THE FAIR DEALING MODEL

CONCEPT PAPER OF

THE ONTARIO SECURITIES COMMISSION

JANUARY, 2004

Table of Contents

Appendices

Executive Summary: What is the Fair Dealing Model?

The Fair Dealing Model is the Ontario Securities Commission's proposal for renewing our regulatory regime to bring it into line with the industry's current advice-driven business model, and to ensure consumer expectations match the services provided. It is not intended to impose another layer of regulation. We hope the model will contribute to healthier competition, strengthened client-adviser relationships, improved investor decision-making, and fewer disputes.

The Fair Dealing Model has two components: a single license for all financial services providers (firms, conglomerates, or individuals), and a set of business conduct standards. These standards aim to achieve understandable disclosure, meaningful communication of expectations, and effective management of conflicts of interest. They are based on observed best practices, and were developed in consultation with people with a wide range of experience in the financial services industry.

The current regulatory regime is out of step with industry reality

The OSC continues to regulate dealers and their representatives through the products they sell, based on an outdated assumption that transaction execution is the primary reason people seek the services of the investment industry. In today's financial markets, advice is what most people seek, and what most firms emphasize in their marketing messages.

We want to change our focus to the relationships representatives and clients form and the services firms provide, including of course investment transactions. Under the modern business model, outside of execution-only services, some form of advice is at the core of any client relationship. The regulations should set clear conduct standards for an advice-driven marketplace, and take into account the broad and integrated range of activities carried out by most financial services businesses.

Self-regulatory organizations (SROs) and industry associations have had the flexibility to set standards that take industry realities into account. These organizations will play an important role in the ongoing development and implementation of the Fair Dealing Model.

The model would regulate on the basis of the relationships people form

The Fair Dealing Model recognizes that dealings between investors and investment representatives are part of a relationship that has been established between those two parties. We propose to establish a regulatory regime that sets out a consistent framework within which such relationships can operate. That framework, to the extent practical, attempts to put the investor and the representative on a level playing field.

For every account opened, people would need to choose one of three relationship types:

- In a **Self-Managed** relationship, the client places no reliance on the financial services provider other than transaction execution.
- In an **Advisory** relationship, the client is entitled to rely on objective, expert advice from the representative.

- In a **Managed-For-You** relationship, the client relies completely on the representative, who has full discretion and assumes a trustee-level responsibility for all investment decisions.

The conduct standards for representatives become more rigorous as the client's level of reliance increases. Many other requirements also vary depending on the relationship type chosen. Proficiency standards vary according to the nature and scope of the services provided.

All rules would flow from three core fair dealing principles

Three principles form the basis of all of our specific proposals.

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

When we applied these principles to the issue of third-party compensation of dealers and their representatives by mutual fund management companies, we recognized that special treatment is necessary to manage the inherent conflict. We are considering three options:

1) Require enhanced transparency
2) Make the fund company responsible for the actions of dealers and representatives it compensates for selling its products
3) Prohibit the compensation of dealers and representatives by third parties

The parties would be required to document all important choices

The "Fair Dealing Document" is an account opening contract that would establish the clear allocation of responsibilities called for by the core principles. It would document the relationship type chosen, the investor's financial situation and objectives, the full range of services to be provided, and the fees to be charged.

The Fair Dealing Document is based on actual examples of best practices in account opening documentation, and would replace a range of existing material. It should be completed interactively so that the investor understands the choices being made. Both parties are responsible for keeping it up-to-date throughout the relationship, recording any significant changes in circumstances. We anticipate that the existence of a Fair Dealing Document will reduce the likelihood of disputes.

The representative's responsibilities would be clarified

Representatives and firms would take on greater responsibility for educating or informing their clients. They would be required to make available concise informational materials on the basics of investing. Also, depending on the relationship type, they may be required to assess and interpret information provided by third parties for the client.

Compensation must not be the primary motivator for any recommendation. Any advice should be based on the representative's expert judgment and the objectives agreed upon in the Fair Dealing Document. The appropriateness of recommendations will be evaluated in the context of the overall portfolio for each account, and its Fair Dealing Document.

Representatives and clients will need to monitor the account on an ongoing basis in accordance with the type of relationship and service level they agreed to in the Fair Dealing Document.

Investors would receive higher quality information

Because we define transparency as disclosure that it understandable to the investor, enhanced transparency does not necessarily mean more disclosure. In fact, lengthy, unwieldy documents should be replaced by more relevant communications.

At the time of each transaction, in addition to basic data on price and quantity, investors would receive summaries of the compensation received by their financial services provider, and possibly the risk level of the security and the basis for any recommendation.

Account statements would also be enhanced. Personalized performance information would indicate the investor's actual rate of return based on all funds contributed. Other required content would include the aggregate cost of all compensation and other fees paid during the period, and, depending on the type of relationship, an analysis of the portfolio's risk level.

To meet these transparency requirements, firms will need to improve the way they disclose compensation. The disclosure should clearly state all amounts received, including those paid by third parties. We discuss some of the implications for transactions involving shares, bonds, mutual funds and wrap accounts.

Transition to the Fair Dealing Model

Our next step after this Concept Paper is to form a series of industry Working Groups to discuss important implementation issues. We encourage interested market participants to join one of the groups. The information gathered will help us prepare a cost-benefit analysis on the Fair Dealing Model. We believe that both a cost-benefit analysis prior to implementation, and an impact analysis using key performance measures afterwards, are important tools to assist us in designing the best possible regulatory model.

As we refine our concepts, we will continue to keep our counterparts among the Canadian Securities Administrators informed about the project. The Fair Dealing Model is still an Ontario project, but our ultimate goal is to see it adopted nationally.

Single Service Provider License

We will be releasing a second concept paper describing other aspects of the Fair Dealing Model. In that paper, we will propose to license both firms and individuals under a single service provider license based on a business reality test. Of all the Fair Dealing Model proposals, this simplified registration system will likely be the largest source of reductions in costs and "red tape" for firms.

Summary of Major Proposals

Throughout Parts III and IV of this Concept Paper, important proposals are emphasized in bold, italic, indented text. Readers can gain a quick understanding of the Fair Dealing Model by scanning through the document and reading only those proposals. For your convenience, we have listed them all here, along with a page reference indicating where the proposal appears.

Core Principles of the Fair Dealing Model

A model based on relationships

The Fair Dealing Model would base regulatory standards on the relationships people and firms form, rather than the products they buy and sell. 18

For each account, investors and representatives would need to choose one of three relationship types: Self-Managed, Advisory, or Managed-For-You. 19

Self-Managed relationship

In a Self-Managed relationship, the investor does not rely on the firm for anything beyond execution. 20

Advisory relationship

In an Advisory relationship, the investor makes decisions in reliance on the objective, expert advice of the representative. 22

Managed-For-You relationship

In a Managed-For-You relationship, the investor relies completely on the adviser, who assumes a trustee-level fiduciary responsibility for all investment decisions. 23

Fair dealing principles

To achieve fair dealing, our regulations must reflect three fundamental principles: 28

1) There should be a clear allocation of responsibilities.
2) All dealings with retail investors should be transparent.
3) Any conflicts of interest should be managed to avoid self-serving outcomes.

Principle #1: Clear allocation of responsibilities

The roles and responsibilities of the investor, the representative and the firm must be clearly established and documented when the relationship is formed. 29

Principle #2: Transparency

Transparency is disclosure that is understandable to investors. Relevant information should be communicated at the time and in the manner most likely to be useful to the investor. 31

The Fair Dealing Model would set standards for transparency in four key areas: the essential features of the investment, risk, compensation, and account performance. 32

I. Introduction

Project background and objectives

The "Fair Dealing Model" is an Ontario Securities Commission proposal to significantly reform the way the retail investment industry is regulated. While the ideas could be applied to other sectors such as insurance, in developing the model we have not looked beyond activities within our existing jurisdiction.

We began this project as a result of two developments. In 1999, the Canadian Securities Administrators committee on financial planning proficiency standards identified conflicts of interest in financial planning advice as a more significant concern than representatives' proficiency. The CSA committee undertook to pursue this area as the second phase of the Financial Planning Project. Around the same time, OSC Chair David Brown determined that changes in the social and economic environment, and in the business structures and objectives of the securities industry, warranted a fundamental re-examination of the regulations governing the delivery of financial advice to retail investors. He recognized that our regulations are still product-based, as they have been for decades, even though the industry has moved to an advice-based business model. In early 2000, the OSC launched the committee that has led to this Concept Paper.

Under the Fair Dealing Model, we would begin to regulate on the basis of the relationships formed between investors and financial services providers, rather than on the basis of the products they buy and sell. The Model would impact a wide range of the day-to-day activities and procedures of market participants. Yet at the same time, it is specifically designed to reflect the way they do business already. It represents our attempt to modernize the regulatory framework to meet the challenges of today's investment industry marketplace.

We've already referred to two of the Fair Dealing Model's major goals: addressing the conflicts of interest that are inherent in many client relationships, and updating the regulations to reflect the business model. Another key objective is to encourage all market participants to adopt the industry's best practices. There are very few proposed requirements in this paper that have not already been implemented voluntarily by industry leaders who believed they made good business sense.

We hold high expectations for the outcomes of this project. We believe the Fair Dealing Model will promote healthy competition for investors' business, based on quality and value for services. It should strengthen and clarify the relationship between financial services providers and their clients, allowing them to better understand their mutual expectations, roles and responsibilities. From the investor's perspective, it should improve the quality of information and advice that clients receive, leading to more informed decisions, and an increased level of confidence in their financial services providers. Ultimately, it should reduce the number of disputes between clients and their financial services providers. In our view, outcomes like these are synonymous with the notion of "fair dealing".

The product of in-depth consultations

The Fair Dealing Model is the outcome of a consultation process that has been as broad and deep as any the OSC has undertaken.

Industry Committee to Rethink the Regulation of Advice. In February, 2000, the OSC established an advisory committee of senior investment industry participants. The Fair Dealing Model Committee members are listed in the table on the next page. Membership has fluctuated over the three years of the Committee's existence.

The Fair Dealing Model Committee's mandate was to evaluate the way the OSC regulates the investment industry in view of its evolution to advice giving and asset gathering. The Committee was asked to identify areas where current regulations are excessive or misguided, or where they fail to adequately protect investors. Committee members were instructed to approach the project assuming they had a "blank slate" to make any necessary changes.

Problems the Committee identified included compensation biases and other conflicts of interest, confusion of roles and responsibilities between representatives and clients, lack of knowledge or misunderstanding of basic financial facts, and misplaced reliance. The Committee also found that the current registration system for retail financial services providers does not match the industry's current business model, resulting in gaps, over-regulation, inconsistency and excessive compliance costs.

We believe the problems faced by both industry and investors are rooted in the same underlying regulatory deficiencies – outdated classifications and misplaced emphasis. We believe that by correcting these we can solve the problems. The Fair Dealing Model is the outcome of this work.[1]

Stakeholder focus groups. We presented the core ideas of the Fair Dealing Model at a series of seven focus group meetings held in April and May, 2002. In total, more than 50 industry participants attended, including senior executives, advisers, and specialists in compliance, information technology and industry operations, marketing, and legal matters.

Many focus group members acknowledged that the problems we identified are significant ones for the industry, and supported the basic approach we proposed, but in general the focus groups required more practical details before giving a final assessment. They expressed concern about the prospect of excessive paperwork, and urged us to keep things simple. The facilitator's report on the focus group discussions is available on the Fair Dealing Model website, and has not been republished here.

1 The Fair Dealing Model is an OSC proposal. Not all Committee members agree with every aspect of this Concept Paper, though they support its overall direction. Committee members were selected for their diverse viewpoints, as well as their depth of experience.

Fair Dealing Model Committee

Member	Professional background
Philip Armstrong	President and CEO, Jovian Capital Corporation. Formerly CEO and Director, Altamira Investment Services Inc. Past Chairman of IFIC and the MFDA.
Paul Bates	Currently a management consultant, faculty member at Rotman School of Management, and OSC Commissioner. Previously a TSE Governor, IDA Director, and CEO of Charles Schwab Canada.
Paul Bourbonniere	Principal, Polson Bourbonniere Financial. Formerly Chair of the Life Underwriters Association of Canada.
Christine Butchart	Independent financial planner with Assante Capital Management. A former Director of the Ontario Association of Financial Planners.
Sean Church	President and CEO, Recognia Inc. Previously held senior positions with Charles Schwab Canada and Versus Technologies. Past Chairman, Ontario District Council of the IDA.
Warren V. Collier	Principal, Counsel and Secretary, Barclays Global Investors Canada Limited. Past Chair, Industry Regulation and Taxation Committee, Investment Counsel Association of Ontario.
Anthony Davidson	Chartered Accountant specializing in securities litigation support. An author and columnist on investor protection issues.
Shaun Devlin	Director of Enforcement, Mutual Fund Dealers Association. Has held senior compliance and legal roles at Assante, CIBC, and the Pension Commission of Ontario.
Robert Goldberg	President and CEO, e3M Investments Inc.
Ann Marshall	President, James P. Marshall Inc.
Bret Mecredy-Williams	Executive Director, Corporate & Regulatory Affairs, CIBC Wood Gundy.
Colman O'Brien	Executive VP & Director, Private Client Group, First Associates Investments Inc. Formerly President of BayStreetDirect.com, and Managing Director and Senior VP of TD Evergreen.
Colleen Parrish	President and Plan Manager of the OPSEU Pension Trust. Has held senior legal and policy positions in the Ontario Government, including the Insurance Commission and the Ministry of Financial Institutions.
Brian Peters	President and CEO, RBC Dain Rauscher. Formerly National Director, Private Client Division, RBC Investments.
Peter Russel	Formerly a Vice-President and Director, RBC Investments.
Ross Sherwood	President and CEO, Odlum Brown Limited. A Director of the IDA, and Governor of the Investor Learning Centre. Past Chairman of the VSE.
Rene Sorell	Partner in McCarthy Tetrault's Corporate Finance and Mergers and Acquisitions Group. A former chair of the OSC's Securities Advisory Committee. Co-author of *Private Placements in Canada*.
F. Michael Walsh	Currently Chair of the Board of Governors of the University of Guelph, and a Director of Kingsway Financial Services Inc. Formerly a Senior Vice-President and a Director of First Marathon Securities Limited.

Fair Dealing Model website. Suggestions made at the focus groups led to the creation of a special purpose website designed to illustrate the model and solicit more feedback. We launched *www.fairdealingmodel.ca* in October, 2002. The site presents simulated client meetings under each of the three proposed relationship types, as well as samples of the required supporting documentation.

By all measures, the website has been a success. It was described in the Canadian business press as an innovative approach to stakeholder consultation with significant investor education value. It was even designated as a "Macromedia Site of the Day" for innovative use of FlashMX technology. Not counting the spike in "hits" on that day, the site has logged over 10,000 visitors – a figure that includes repeat visits, meaning that a somewhat smaller number of individuals has viewed the contents. Most importantly, over 300 of the visitors submitted comments. We received input from market participants (roughly 20% identified themselves as investors, the rest as advisers) who typically would not comment on OSC proposals. In Appendix G we've summarized the comments, as well as the results of specific survey questions we posed on the website.

Other consultations. OSC staff members have presented the Fair Dealing Model to conferences, trade associations, and informal industry groups. We have also worked to keep other regulatory agencies updated on our progress.

The ongoing consultation process has increased awareness of this project, and challenged us to make improvements where weaknesses were identified. Now that we are presenting the ideas in a formal concept paper, it is more important than ever that we continue to benefit from the feedback and participation of market participants. We describe the comment process in Part V, along with a series of Working Groups we plan to establish to work on implementation issues.

About this Concept Paper

Major proposals. We've identified proposals that represent core elements of the Fair Dealing Model by presenting them in bold, italic, indented text. These proposals can generally be interpreted as the "mandatory" aspects of the model, or as requirements that would constitute a significant change from the current regime. In other words, we believe that even readers who are skimming through a section will want to read them. The surrounding text elaborates with supporting details or rationale. We have listed all the major proposals at the beginning of the paper, starting on page vii.

Detail level. When we've presented aspects of the Fair Dealing Model to industry groups, a common reaction has been a request for more details. People want to understand the impact of the model on their day-to-day activities, and on their routine communications.

Our ability to offer details is somewhat constrained by the fact that this project is still in its early stages. A concept paper is intended to communicate an overall vision so that people can consider a new idea on its merits. It is not designed to propose specific wording for new regulations; after all, rules cannot be drafted before consensus is achieved on basic directions. Much of this paper therefore focuses on the "big picture".

That being said, we agree that readers need to have an opportunity to react to something concrete, so we've included specifics wherever we could. Where a major proposal raises practical implementation issues we attempt to address them. Where a proposal could be satisfied with a number of alternatives we discuss their merits. And we have created sample documents to depict the kind of investor communication materials we envision after the Fair Dealing Model is implemented. (For example, see Appendices A, B, C, and E.)

The inclusion of sample documents should not be interpreted as an intention on our part to prescribe specific wording or formatting. There will certainly be acceptable or superior alternatives to what we have created, and we do not wish to stifle the industry's creativity. The samples illustrate the kind of documentation that would satisfy our proposed requirements, and provide a basis for comment or further discussion. Similarly, the inclusion of other practical details is not intended to signal our unwillingness to consider other possibilities.

Text boxes. Our stakeholder consultations have alerted us to common questions and concerns about various aspects of the Fair Dealing Model. Throughout the paper, we present some of these questions, together with our responses, in a "Question & Answer" format in a series of text boxes.

The other use we make of text boxes – in this case shaded boxes – is to request comment on specific questions. While we welcome your comments on any aspect of the Concept Paper, there are specific issues we wish to flag for your consideration. Instructions for submitting written comments are provided at the very end of the main body of the paper.

Terminology. Before reading further, it will be useful for readers to understand a few of the decisions we've made about terminology in this paper.

As most of you will be aware, the language people use to refer to the participants in the financial services industry can be confusing. Job titles for people in similar roles can vary widely – but individuals most people refer to with names like financial planner or investment adviser are actually classified as "salespersons" under the *Securities Act*. The word "adviser" is very commonly used, but under the regulations it is confined to a small number of portfolio managers and newsletter publishers. And the use of words like "dealer" to refer to firms implies (wrongly, in many cases) that they are engaged only in a narrow range of activities, rather that a wider spectrum of financial services.

This illustrates one of the problems we highlight in Part II: a lack of clarity. If industry insiders cannot agree on vocabulary, imagine how the average investor must feel. The Fair Dealing Model aims to improve clarity in a number of ways – and perhaps one of them will involve defining or redefining some terms. But we're not at the drafting stage yet. For now, our goal is that readers at least have a consistent, unambiguous understanding of the language in the Concept Paper. As regulators, we're more reluctant than most to stray from the official terminology, but we'll do it occasionally in the name of readability.

Following are some of the terms we use in the paper:

- "**investor**" is often used interchangeably with "**client**".
- "**representative**" describes an individual providing services to clients on behalf of a firm. We use the word in a broad sense that includes any salesperson, adviser, financial planner, etc.
- "**adviser**" is used much less frequently than "representative," because it is not as broadly applicable. We assume the common usage meaning of this word, not its *Securities Act* definition. We only use "adviser" to refer to someone who provides services beyond a sales role.
- "**firm**" refers to any business entity that provides financial services, including sole proprietorships. We recognize that firms act through representatives and that vicarious liability will attribute the actions of the representative to the firm. To streamline our discussion of the obligations of financial services providers we assume this but do not always make it explicit.
- "**dealer**" is most often used in this paper in place of "firm" when we are speaking in the context of mutual funds, so as to avoid possible confusion with the fund management company. Includes Investment Dealers Association (IDA) and non-IDA member firms.
- "**financial services provider**" can refer to a firm, a representative, or both. We often use this term when an obligation can apply to either. It is broad enough to reflect firms of all sizes.
- "**trades**" include transactions in all instruments that fall within the definition of a security, including mutual fund units.
- "**regulations**" generally refers to the body of securities law in Ontario over which the OSC has jurisdiction, including the *Securities Act* and related statutory instruments. It is not necessarily intended to refer to the total body of rules from various sources (including self-regulatory organizations) that currently govern the activities of financial services providers.

II. The Need for a New Approach to Regulation

The Fair Dealing Model represents a significant change from the way the relationship between investors and financial services providers is currently regulated. We recognize that there are transition costs involved in introducing a new regulatory model, and that the onus is on us to justify why it is necessary.

Generally, as regulators, we are able to address market needs through more incremental policy changes. But we believe the financial services marketplace has changed so significantly in the decades since the current regulations were developed, that further incremental changes are no longer adequate to address the challenges we all face. The regulations are built on assumptions that no longer hold true.

In Part II we describe three major problems with the OSC's current regulatory approach.

1) 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.
2) The regulations allow an unacceptable lack of clarity which contributes to many of the problems in relationships between investors and advisers.
3) The regulations have fallen behind the evolving common law. Firms that comply with the regulations still risk running afoul of courts' expectations.

On the basis of these problems, we have concluded that the OSC's existing regulations no longer serve the needs of the industry or investors very well.

Product-based regulations have not kept pace with changes in the marketplace

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.

What is a "product-based" regulatory model?

Generally, the *Securities Act* regime regulates most financial services providers through the products they sell. 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, although much has changed in response to changing needs.

Most fundamentally, product-based regulation means there are different sets of rules, and even different regulators, for different types of investment products. Certain obligations, such as the requirement to register, are triggered on the basis of the security being traded. Business conduct standards can vary for a firm depending on the type of investment it is selling. The regulations focus on the differences between various investment vehicles rather than their similarities.

Product-based regulation is a remnant of the “four pillars” concept, which once restricted financial services firms to operating in just one of the banking, securities, insurance or trust sectors. Licenses and their criteria were designed to regulate all of a licensee’s market activities. The constraints of the four pillars were lifted nearly 20 years ago, and many firms have chosen to operate in more than one of the sectors. Yet they must still obtain multiple licenses – which are often duplicative or inconsistent – administered by different regulatory agencies, whose authority is limited by the four pillars and products within the pillars.

Our continued adherence to this approach yields predictable results. Similar activities are regulated differently, standards are uneven, and the regulatory environment is unnecessarily complex and costly for market participants.

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. Most advice provided to investors is treated as secondary or incidental to the trade,[2] and therefore remains exempt from any clear, concrete standards. The fact – ignored by these regulations – is that the trade has become incidental to the advice.

Firms sell advice, not products or transactions

Many firms in the investment industry have shifted from transaction-based business models to advisory business models. The elimination of the four pillars contributed to this shift, as did the deregulation of commissions, the advent of new technologies like the Internet, and normal competitive forces. Only a few niche providers, such as discount brokers, now build their business primarily around the simple execution of trades. Ongoing asset management has become a more lucrative business.

Most major financial services firms now share a similar strategy of expanding their client relationships as widely as possible to manage a range of the client’s financial needs. Their product and service offerings might include mutual funds, equity, debt, deposits, lending, life insurance, RRSP and RESP tax deferred investments, and tax and estate planning. The marketing messages of these firms tend to emphasize their ability to offer comprehensive, objective, personal financial advice and asset management. Their ability to execute trades is a given, and is rarely mentioned.

2 For example, see section 34 (c) of the *Securities Act* (Ontario).

Investors do not view investments as “products”

When people select a financial services provider, what they usually seek is expert knowledge and advice, not merely an ability to execute transactions. Investors don’t consider an investment to be a one-time purchase of a tangible product to be consumed over time, like a car or an appliance. Investing is a process whereby people entrust their money, generally for the long term, with an expectation of earning a return. It carries with it notions of confidence and trust. Each transaction is in reality part of an ongoing relationship that investors form with a financial services provider.

It is this relationship that is important both to clients, and to firms that attempt to leverage it over time to grow their business. To the extent that they ignore the relationship, our current regulations are out of step with the marketplace. By starting from the flawed premise that investments are simply products, and that we can protect consumers by regulating "sales practices", we have limited our regulatory tool kit.

Lack of clarity where things ought to be clear

Our current regulations are rigid where they should be flexible, and ambiguous where they should provide certainty. As a result, a number of crucial aspects of the relationship between investors and their advisers are often left unclear. And in many key areas, investors’ expectations do not match the services or service level the firm or representative is prepared to provide.

Conflicting interests and loyalties

Representatives who undertake to advise clients about their investment choices, or more broadly, about their personal financial situations, can find themselves in difficult situations where the best interests of their clients are not aligned with their own interests, or those of their employer. Investors rightly expect that any advice they receive is influenced solely by their own investment needs and objectives, and fairness dictates that they should be told when this assumption is not valid. But the industry’s compensation practices can often introduce conflicting incentives.

Despite the shift, described above, to a business model based on advisory services and long-term relationships, most individuals employed to deliver advice and execution services to retail investors are rewarded only for sales. Compensation structures typically reward representatives for volume of transactions, particular investment recommendations, or the accumulation of assets under management by the firm. And many would argue that compensation drives behaviour. In some cases, representatives may also experience pressure from their employer to achieve specified sales targets.

To illustrate, we list a number of situations where advisers can be influenced by factors contrary to their clients’ best interests.

- Representatives compensated by commission alone receive no immediate financial benefit for recommending strategies that do not involve a purchase or sale, even where they represent the best option for the client.

- They can benefit, however, from recommending uneconomic trading activities such as the churning of portfolios, or the unnecessary redemption and repurchase of back-end load mutual funds once the redemption fee of the original fund has fallen to zero.
- Third parties, such as fund management companies, compensate dealers directly (and representatives indirectly through their dealers) – out of funds ultimately supplied by the investor – for recommending certain securities. The amount of this compensation can exceed any commissions paid directly by the client, and is usually not transparent to the client.[3]
- Full service investment firms may offer special incentives for their retail representatives to support other business units, such as investment banking, which may have an interest in pushing a certain product.

The common thread in each case is competing loyalties. One can legitimately question whose interests the representatives are serving. They are being pulled in multiple directions by their client, their employer, third parties, and their own need to be compensated for the services they provide. The problem is magnified to the extent that the client is not fully aware of the nature and amount of compensation being received.[4]

Our purpose in describing these conflicts is not to assert that abuses are rampant, although there is no doubt they do occur. Rather, our point is that the current regulations are of little assistance in managing these conflicts. They offer little guidance or clarity to advisers wrestling with real life situations – only generalities such as the requirement to "deal fairly, honestly and in good faith with his or her clients."[5] And from the perspective of investors trying to understand the effect of conflicts of interest, the specific rules that do exist can lead to disclosure that is either narrow and complex, or boilerplate and uninformative.[6] Because the rules for dealers and their representatives largely ignore the impact advice can have on the client, they fail to set high standards for managing conflicts in the advice process.

What role should regulation play? It is not the regulator's place to prohibit conflicts entirely, nor to interfere in the industry's long-established compensation practices. But we can still make a useful contribution by providing better guidance for advisers who need to manage conflicts of interest, and more transparency for investors who need to understand them.

---

3 In Appendix F, we provide case studies illustrating how mutual fund compensation can be non-transparent to the average investor, even where it is disclosed in a prospectus.

4 Concern that the compensation methods developed by the financial services industry may result in a lack of alignment between the interests of retail investors and their advisers is by no means unique to Canada. Reports in the United Kingdom, United States, Australia and New Zealand have also found problems with inadequate transparency and conflicts of interest in connection with compensation practices. See Appendix F.

5 OSC Rule 31-505, s.2.2

6 For an example of narrow disclosure requirements, see National Instrument 33-102. An example of a requirement that leads to boilerplate disclosure is Regulation 1015, Part XIII.

Roles and responsibilities

Upon entering into a relationship, both investors and representatives form a number of expectations about the roles and responsibilities each is taking on. For example, how frequently (if ever) will the representative review the client's portfolio to ensure it maintains the correct asset mix? Is the investor aware he is responsible for notifying the representative of major life changes that might impact his investment objectives? Does the representative have a duty to object to any requests by the client to make unsuitable trades? What kind of information will the representative provide to support her recommendations? Is the investor expected to independently scrutinize the advice before making a final decision?

Misunderstandings are likely if topics like these are inadequately covered. Investors who don't often open investment accounts are particularly vulnerable to making false assumptions. Yet the regulations do not currently require the parties to discuss their basic roles and responsibilities, let alone document them.

A lack of clarity in this area can contribute to a number of undesirable outcomes. A client might not fulfill some aspect of the role his adviser expects him to play, either because he is unwilling to do so or does not understand the expectations. Or the investor could be dissatisfied that his own expectations have not been met. Opportunities might be missed to address problems at an early stage. And in the event of significant losses, a full-blown dispute could arise – in which case, the absence of documentation would make a fair resolution more difficult to achieve.

There is a wide gulf between the minimum standards set out by regulations and the industry's best practices. The "know your client" (KYC) form currently prescribed is believed by many to give inadequate treatment to issues such as risk tolerance and investment policy, the nature of services offered, and the responsibilities of each party. (On this point there was no disagreement within the Fair Dealing Model Committee.)[7] Firms that rely on the basic KYC may be missing opportunities to clarify important issues at the beginning of the relationship, to provide the best possible recommendations to their clients, and to reduce the likelihood of subsequent disputes.[8]

Many firms have recognized the benefits of exceeding the minimum requirements, and have established very good account opening documents. In fact, in developing the model Fair Dealing Document and other account related material we introduce in Part III, we cribbed extensively from excellent documentation already in use by some industry players, including engagement letters, investment policy statements, client information brochures, and portfolio statements. One of our major goals is to raise the bar so that all investors – regardless of the firm they choose – can benefit from best practices like these.

---

7 The Regulatory Burden Task Force, in its December, 2003 report to the OSC, highlighted deficiencies in the KYC form and the account opening process generally. Market participants interviewed by the Task Force described the process as voluminous and needlessly complex, yet vague and inadequate in dealing with some important issues.

8 We note that a working group of the IDA's Compliance and Legal Section is reviewing IDA Form 2, the standard New Account Application Form (KYC). This process represents an opportunity to implement some of the proposals in this Concept Paper.

Information necessary for decision-making

The current regulatory framework is aimed at making sure investors receive information about specific investments in many circumstances, but it does not concern itself with investors' need to understand the information and apply it to themselves. Under our current model, final decision-making responsibility rests on investors, but the regulations fail to ensure they have adequate tools to make effective choices. In particular, investors lack clear information about the performance of their investments and the risks they are facing.

The performance information mandated by regulations is minimal. The periodic account statements firms are required to provide show an opening and closing balance. But they do not usually inform investors of their personalized rate of return which takes into account any securities bought and sold during the period, and they fail to reflect longer term performance. Furthermore, the actual compensation and other costs paid by the investor are not completely transparent.

The net effect of current reporting requirements is that investors are not seeing the complete picture of their own account performance. Their ability to raise red flags for results that fall short of agreed objectives, or to evaluate the effectiveness and value of their adviser's recommendations, is hindered.

In addition to past performance, informed investors need to be aware of the risks they face going forward. We need not look back any further than the last stock market bubble for a reminder that the concept of risk is not well understood by large segments of the investing public (to say nothing of advisers). But other than general business risk disclosure in prospectuses and a implied reference to client risk tolerance in the suitability rule,[9] the regulations do not mention or contemplate risk concepts. To make the decisions they are expected to make, investors need a better understanding of the risks of their overall portfolio and of individual securities, both at the point of sale and through their account statements.

A more general question is how people can be expected to become literate about investments in the first place. Government bodies such as the OSC have a mandate to deliver investor education materials to the general public, but no one currently bears that responsibility at the individual client level. Even an adviser who has a personal relationship with a client and is paid to make recommendations and provide advice to him is under no obligation to provide him with educational information. Advisers are required to determine an investor's sophistication level – but this is done for suitability and KYC purposes, not to help clients improve their knowledge.

There is extensive research data available showing that many investors are not well equipped to make the transaction decisions they would be expected to make, albeit with assistance, in an advisory relationship.[10] The representative cannot, of course, be responsible for a client's

9 OSC Rule 31-505, s. 1.5(1), requires registrants to "ascertain the general investment needs and objectives of the client and the suitability of a proposed purchase or sale of a security for the client." It does not specifically mention that risk is an element of suitability.

10 See, for example: The Brondesbury Group, *Financial Literacy Research*, report prepared for the Investor Education Fund of the OSC, 2003; "Investment Literacy Test", administered for Cartier Partners, reported at www.cartierpartners.ca, September 18, 2002; Hersh Sherfrin, *Beyond*

thought processes. However there are two reasons to propose a more formal role for the firm and its representative in providing educational opportunities to clients. One is that the time when clients are dealing with their accounts is a "teaching moment" when they are most likely to be receptive to absorbing this information, properly presented. The other is that Canadian courts have held that it is part of the representative's duty of care on behalf of the firm to make sure that a client understands the transaction or strategy they are approving. A breach of this duty can lead to a client recovering in negligence for market losses, even where the advice itself, considered objectively, may have been appropriate.

While we cannot expect advisers to ensure that their clients understand everything about investing, we believe there are opportunities to provide investors with information that will better enable them to understand particular decisions. We propose our ideas in Parts III and IV.

Once again, some firms have elected to exceed requirements in the areas discussed above, but not all investors benefit when the regulations fail to set a minimum standard.

Regulations have been less responsive to industry evolution than the courts

Our regulations continue to make distinctions based on decades-old assumptions. We distinguish between dealer and adviser firms, and classify employees as either advisers or salespeople. The courts, on the other hand, have recognized that these distinctions are outdated.[11]

Courts have been more effective at setting standards for advice

When faced with disputes involving retail investors and representatives, courts are not interested in labels. They look beyond the registration category or the type of security traded to consider the real nature of the relationship between the parties. Where a representative holds herself out to clients as providing advice, and invites reliance on the objectivity of her advice, courts will treat her as an adviser. The fact that she may be registered as a "salesperson" is unimportant to

---

Greed and Fear, Understanding Behavioural Finance and the Psychology of Investing, Harvard Business School Press, 2000; *Canadian Shareowners Study 2000*, The Toronto Stock Exchange Inc. and World Investor Link; *Canadians' Knowledge and Awareness of Financial Products, Services and Institutions*, FCAC Survey: Final Report, Financial Consumer Agency of Canada, 2001; William Jahnke, "Are We Heading For Disaster?" Journal of Financial Planning, December 2001; Brad Barber and Terrance Odean, "Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors", The Journal of Finance, 773, April 2000; Haing Chen and Ronald P. Volpe, "An Analysis of Personal Financial Literacy Among College Students", Financial Services Review, 7(2): 107 (1998); Donald C. Langevoort, "Angels on the Internet: the Elusive Promise of 'Technological Disintermediation' for Unregistered Offerings of Securities", JSEBL V. 2, summer 1998 No.1; Industrial Math Lab Inc., *Feasibility Analysis for Risk Tolerance Assessment and Risk Awareness Training for Consumer Investors,* report to the OSC, 1997; and Henry Hu, "Illiteracy and Intervention: Wholesale Derivatives, Retail Mutual Funds, and the Matter of Asset Class", 84 Geo.L.J. 2391 (1996).

11 We will elaborate on much of the legal analysis found in this section and throughout this Concept Paper in a separate appendix to be released shortly.

judges, who are aware that it is common for salespeople to deliver advice to retail investors. On this basis, courts apply similar standards to everyone who provides expert financial advice.

Courts have articulated a number of duties for those who offer expert financial advice. Judges recognize the importance of clear and unambiguous account documentation. They understand that there is a need for advisers to clearly establish the nature of their relationship with each client, and that the client's level of reliance on the adviser may change over time. And they have found that advisers have a responsibility to educate clients, and to assess and filter information for them.

In contrast, as we noted earlier, advisers looking to the regulations for guidance in these areas will tend to find only generalities like the duty to deal fairly, honestly and in good faith. Such regulations are effectively little more than an endorsement of industry standards, and therefore make no additional contribution, even where one might be needed. When disputes reach the courts, advisers can find that having met an industry standard or firm practice will not protect them if they have failed to meet their duties in common law or equity. Courts look to industry practices as indicators of an appropriate duty or standard of care, but are not bound by them if they consider them to be inadequate. The result is that even those firms and representatives who follow industry norms and satisfy all regulatory requirements are at risk of falling short of a court's expectations.

Regulation is a better tool for setting standards

Courts have been more effective than regulators at adapting to changing industry circumstances, and they play an essential role in applying legal standards to the facts of each case. But there is no need to rely on judges to set those standards when regulation can and should do it better.

There are disadvantages to establishing conduct standards on a case-by-case basis. While courts apply general legal principles in reaching their conclusions, their decisions are aimed solely at ascertaining the rights of particular parties after a loss has occurred, and therefore they do not necessarily offer specific guidance to all those who face conduct dilemmas. Outcomes can vary across jurisdictions, or from one case to the next. Researching and analyzing the case law can be highly time consuming from a compliance perspective. The difficulty of sorting out complex business activities, legal doctrines and regulatory principles can lead to questionable analyses by a non-expert judiciary.[12] And on occasion, when used as a means of assigning liability for investors' losses, purely legal notions of duties of care and the application of fiduciary principles may produce results most observers would consider unfair.[13]

---

12 See, for example, *Hunt v. TD Securities Inc.*, 2002 O.J. No. 474 (BCCA). A broker persuaded the client to diversify his portfolio, which had been allocated entirely to a single stock. In ruling against the broker, the court seemed to interpret the "know your client" principle to mean that the broker should have been more sensitive to the client's "feelings" about that stock. The Ontario Court of Appeal subsequently overturned the decision. We discuss this case in more detail in a separate appendix to be released shortly.

13 See, for example, *Zraik v. Levesque Securities Inc.*, 2001 O.J. No. 5083 (OCA). An investor pursued a high-risk investment strategy against his broker's fervent advice. He recovered all of his losses when the court ruled the firm had been negligent in allowing him to consistently exceed margin limits, even though the investor was sophisticated enough to understand the risks he was taking.

A regulatory approach can offer greater clarity and certainty than an evolving series of cases. Whether it takes the form of legislation, rules, policy statements or notices, regulation is easily accessible and generally applicable to all market participants. It enables firms to take concrete steps to comply with standards. And any reduction in ambiguity can pre-empt many of the disputes we traditionally see, thus reducing litigation and settlement costs.

As we have seen, regulations can fall behind if they become entrenched and slow to change. But when they are relevant and reflective of the needs of market participants, regulations can make a positive contribution.

Regulation could do more to resolve disputes

The fact that our regulatory requirements are not very helpful to courts or litigants attempting to resolve disputes is an indication of misplaced regulatory emphasis. There are two roles regulation could be playing far more effectively.

The first would be to require better documentation and reporting, both at account opening and on an ongoing basis. This would give courts the information they need to establish the key facts they usually seek, such as the nature of the relationship the parties had, and their mutual expectations. When judges are forced to reconstruct this evidence like detectives, litigation outcomes become less certain. Aggrieved investors can have a hard time demonstrating conclusively that they have been wronged, while firms and representatives are more vulnerable to frivolous claims.

A second improvement to our regulatory approach would be to set clear standards of conduct for representatives that resolve the fundamental conflict between sales and advice. As explained above, this would create greater certainty for everyone, including judges who need to know which standards to apply. Much of what we propose in this Concept Paper would codify the principles that the courts have already articulated. The Fair Dealing Model would preserve the higher standards courts have established, but with all the advantages a regulation-based solution offers.

Q: Are you criticizing the business practices of the financial services industry?

A: Our intention is not to criticize, but to identify problems that need to be solved. In many cases, we have found fault with ourselves as regulators for failing to keep up with market realities. Firms are simply operating within the existing regulations, which is exactly what we expect.

Q: Are the problems identified in Part II causing any real harm, or are they merely hypothetical?

A: The case studies in Appendix F illustrate possible financial consequences of compensation biases. The results from our website survey, shown in Appendix G, show significant agreement that these problems represent significant concerns for investors and the industry. There is a considerable amount of academic writing and research on conflicts of interest and confusion around suitability assessments in the securities business, and on the relatively poor performance of individual investors compared to the overall markets.

Coordinating with Self-Regulatory Organizations

Up to this point, the discussion in Part II has focused mainly on the regulations for which the OSC has direct responsibility. While some financial services providers are regulated only by the OSC, the rules applicable to many others are also administered by self-regulatory organizations (SROs). Other industry organizations also set standards governing conduct, disclosure and proficiency that their members agree to uphold. Many of these requirements address the relationships among clients, representatives and firms more directly than current OSC regulations.

The OSC's statutory powers allow it to recognize SROs whose rules provide an adequate substitute for direct OSC regulation and require it to monitor recognized SROs. By virtue of recognition, an SRO must regulate the operations and the standards of practice and business conduct of its members and their representatives in accordance with its by-laws, rules, regulations, policies, procedures, interpretations and practices. The importance of the role of self regulation is acknowledged in section 2.1 of the *Securities Act.* While moving away from product-based regulation, the Fair Dealing Model would support a continuing important role for SROs.

The implementation of the Fair Dealing Model would require an analysis of the total body of rules applicable to financial services providers, including those of SROs such as the IDA. Any rules developed from the proposals set out in this paper would have to consider the existing IDA rules that regulate the adviser-client relationship. Based on preliminary discussions with the IDA, we expect to find that many existing IDA rules are already consistent with aspects of the Fair Dealing Model, while others may need to be adapted, extended or otherwise improved. Where possible, we understand that IDA rules will be developed or amended to codify the Fair Dealing Model.

Following this approach for SROs and other standard setting bodies would help ensure that the likelihood of duplicative and potentially inconsistent rules relating to fair dealing is minimized. The normal SRO industry consultation process can also assist in the timely development of rules of practical application without sacrificing the principles of the Fair Dealing Model.

Why now?

In our view, the urgency of the Fair Dealing Model is due primarily to the importance investing has taken on for Canadians in recent years. Close to half of the population now participates in the capital markets. The decline in the number of people who can expect their retirement needs to be fully met through company pensions or government programs has increased the importance of RRSPs and other investments. The standard of living of millions of people depends on a reasonably successful outcome to their investment strategies.

Having been encouraged or compelled to rely so heavily on the financial services industry, Canadians deserve the best possible regulation of that industry. Firms now offer an extensive array of investment choices, particularly of managed funds, to people who once would have been only depositors and life insurance policy holders. And the expectations of a lot of investors –

many experiencing their first bear market – burst along with the recent stock market bubble. Media and even politicians (primarily in the U.S.) have been drawing attention to perceived conflicts in the industry. In this complex investment environment, adviser relationships are arguably more important than ever before. It is no longer acceptable to regulate advice as though it were merely incidental to a sale. People need to be assured of getting fair treatment from their adviser.

Another timing-related consideration is that the investment industry is currently preparing to invest in broad technology upgrades. The impetus includes the move to straight-through processing, and the need for a more seamless connection between client-related data and transaction processing data management. It may be more efficient for firms to make any technology changes related to new regulatory requirements at this time.

One thing to keep in mind is that the Fair Dealing Model is still several years away from being implemented. In Part V we outline the steps that will follow this Concept Paper.

III. Core Principles of the Fair Dealing Model

In Part II of this paper we identified areas where significant improvement is needed in the way we regulate the retail investment industry. We will now describe the basic principles underlying a refocused regulatory model designed to address those concerns by recognizing marketplace realities. Part IV is more practically oriented, setting forth the specific requirements that flow from these principles.

We recognized early on that incremental changes to existing regulations – our preferred approach whenever possible – may not be sufficient to meet our objective that our regulations are appropriate for today's environment. Together with our Fair Dealing Model Committee, we asked ourselves what type of rules we would write to reflect modern business models. We looked at innovative solutions already used in the industry to provide greater operational efficiency and better investor protection. What kinds of regulations are needed to enshrine these best practices across the industry and address regulatory gaps?

The outcome of this process is a refocused regulatory model based on two central ideas:

1) We should regulate on the basis of the relationships formed between investors and financial services providers, rather than the transactions they conduct.

2) Specific rules should be derived from three fundamental principles:
   - roles and responsibilities should be clearly allocated
   - all dealings between service providers and clients should be transparent
   - any conflicts of interest should be managed to avoid self-serving outcomes

The remainder of Part III develops these central ideas.

A model based on relationships

The characteristic that most differentiates the Fair Dealing Model from our traditional regulatory approach is that it is relationship-based instead of product-based.

> ***The Fair Dealing Model would base regulatory standards on the relationships people and firms form, rather than the products they buy and sell.***

This means that the type of relationship determines which set of rules would apply. When opening an account, investors and representatives would select the relationship type they find most appropriate, and each party's specific set of responsibilities would flow from that choice.

The shift to a relationship-based regulatory model reflects modern business practices. The range of activity in the typical retail investment relationship now extends well beyond the occasional sale of securities; advice has become a crucial element of the service offering. It no longer makes sense to distinguish, as our existing product-based regulations do, between “advice” and “trading.” As we described in Part II, our current regulatory system offers little clarity on a number of crucial aspects of the relationship.

By focusing on the relationship itself, we can replace the existing ambiguity with standards that are consistent and known. Courts will no longer have to deduce matters like the nature of the relationship, the client’s expectations, or how the transaction fits into the overall portfolio. They can focus instead on more salient issues like whether an investor failed to inform the adviser of changes in her circumstances, risk tolerances or goals, or whether an adviser has delivered faulty advice, failed to meet the appropriate standard of care, or breached a fiduciary duty. Regulations cannot eliminate litigation or disputes, but they can reduce much of the uncertainty currently found in the process. When the outcome is more predictable, litigation becomes a less attractive course of action for at least one party.

The Fair Dealing Model reflects the fact that some form of relationship exists whenever an individual invests through a financial intermediary. The relationship can be an exceptionally dependent one, as when a client entrusts all her investment decisions to the same firm or representative for many years. Or it can be more limited, perhaps involving just expert stock picking for a small part of her portfolio. An investor who conducts all transactions online may never meet or speak with a human representative, but even she still has a relationship with the firm. The Fair Dealing Model accommodates differing circumstances like these by recognizing that every account can fit into one of three distinct relationship types.

> ***For each account, investors and representatives would need to choose one of three relationship types: Self-Managed, Advisory, or Managed-For-You.***

The factor distinguishing the three is the level of reliance the investor agrees to place on advice provided by the firm (i.e. none for a Self-Managed relationship, partial for an Advisory relationship, and complete reliance for Managed-For-You). The obligations of both the investor and the representative are intended to be appropriate for the level of reliance. In general, responsibilities become more rigorous as reliance increases. We discuss the rules applicable to each relationship type below.

Why three relationships? Some observers have asked why we are trying to force the many varied relationships that thrive in the marketplace into a framework of only three categories. But in reality, the existing regulations apply the same set of general rules to all relationships – effectively allowing for just one category. In our view, a regulatory model that recognizes three distinct relationship types is more attuned to the diversity of today’s investment industry than the traditional “one size fits all” approach.[14]

---

14 We note that the IDA already classifies accounts into four different types, based on the level of discretion exercised by the representative, and on whether or not investment recommendations will be made. This system could easily be adapted to the three reliance-based categories under the Fair Dealing Model. There is no such classification for non-IDA firms.

One might also ask whether three relationship types are sufficient. We did not find it necessary to define the many and varied relationships firms actually form with their clients. We found that three categories allow us to resolve the most troubling ambiguities of the existing regulations simply and efficiently, while minimizing the need for prescriptive rules. As a result, the Fair Dealing Model remains flexible and able to accommodate existing and future variety in the marketplace. In fact, some firms may spot opportunities to introduce service offerings tailored to the newly clarified regulatory requirements.

We designed the relationship categories to reflect what people already do, not to dictate how they should behave. Among the misconceptions we have heard are that the OSC would compel firms to offer all three relationships, and conversely, that we would limit firms or representatives to just one of the three for their entire client base. The fact is that the services offered and purchased will remain the choice of individual market participants. Clients would continue to have the option to enter into multiple relationships with different firms, or with one or more representatives of a single firm.

One reason we consider our model to be flexible is that the parties always have considerable freedom to define a relationship that suits them. The regulations will set out only the basic obligations for each category. Beyond these, many key factors, such as service levels and fees, are at the discretion of investors and representatives. We would require only that the parties document their decisions in a contract we refer to as the Fair Dealing Document, which is created at account opening and maintained throughout the relationship.

We refer to the Fair Dealing Document again throughout Part III, explain it more fully in Part IV, and provide samples in Appendix A. We also offer further guidance in Part IV on selecting the most appropriate relationship type. At this point, it is important to understand some of the basic characteristics of each of the three relationship categories, beginning with the Self-Managed relationship.

Self-Managed relationship

The least rigorous regulatory requirements apply to this first category.

> ***In a Self-Managed relationship, the investor does not rely on the firm for anything beyond execution.***

The firm supplies its sales infrastructure and its ability to execute transactions, but provides no investment advice. It is made clear from the outset that, when making investment decisions, the investor will not rely on any persuasive communications the firm might provide. The investor is fully aware of this, and accepts full responsibility for any investment decisions made. As long as the firm complies with the rules of the relationship, it bears no responsibility for decisions.

This category would clearly be appropriate for a discount broker, or anyone whose service offering consists primarily of filling clients' orders.

In other situations, transaction execution services are also combined with communications intended to persuade investors to allocate their assets in a particular way. An example is employees at a bank branch who present their customers with information about mutual funds, but leave the decision to the client. The representatives provide product information, and are expected to achieve certain sales targets, but they do not undertake to become the client's personal adviser. This too would fall into the Self-Managed relationship category.

A more problematic fact scenario is a representative who establishes longer-term relationships with clients, yet remains primarily focused on sales targets. We believe such a representative should be allowed to operate within a Self-Managed relationship, provided the client has made a clear decision to accept responsibility for critically assessing any communications from the representative. Activities that might be considered self-serving under the conflict management rules applicable to the other relationship types, such as recommending proprietary investments over less costly alternatives, are acceptable here, as long as the basic duties of fairness and honesty are met. The reason is that the clients have agreed not to rely on any recommendations as necessarily in their best interest. It is a "buyer beware" situation. (Analogously, you don't expect a Toyota salesperson to point out that a better deal might be found at the Ford dealership – but then you also don't rely on the Toyota salesperson to give you unbiased advice about your automotive needs.)[15]

What type of clients would be interested in forming a Self-Managed relationship? Some investors may not wish to pay higher fees for the increased service levels of an Advisory account. Examples might include people with simple or inactive portfolios who understand they are forming a limited relationship, and active traders who are comfortable taking on all risks and responsibilities in exchange for low-cost execution.

Representative's obligations. While not responsible for providing customized advice or assessing the suitability of trades, the representative (or the firm if there is no individual assigned to the account) would still owe the investor a number of duties. These include:

- deal with the client fairly, honestly, carefully, and in good faith
- disclose all costs incurred by the investor
- disclose actual conflicts on transactions
- provide the client the logistical information needed to complete transactions
- provide best execution on all transactions
- provide prompt confirmation of transactions
- provide regular account statements

Investor's responsibilities. An investor in a Self-Managed relationship is responsible for verifying, through the information the firm provides, that trading instructions have been properly completed and that confirmations and account statements reflect those trades.

---

15 We refer to this particular situation as "problematic" because there can be an apparent overlap with an Advisory relationship. We elaborate on how we would solve this problem in several pages, in the section titled "Avoiding relationship troubles".

Advisory relationship

Investors who seek investment advice in addition to execution capabilities would likely be more interested in opening an Advisory account.

> ***In an Advisory relationship, the investor makes decisions in reliance on the objective, expert advice of the representative.***

The investor is responsible for making the final decision on any trade. But in making these decisions, it is assumed that the investor is relying on the representative's opinions, and therefore, the representative must meet a certain standard of care. Most importantly, any advice must be appropriate for the client's financial needs and objectives as described in the Fair Dealing Document. Advice must also be unbiased. A firm could be held responsible for investment losses if a court determined that its representative failed to meet the applicable standard of care or breached a fiduciary duty.

We anticipate this relationship category to be the one most frequently selected. It is broad enough to encompass the activities of most representatives who currently refer to themselves with labels like investment adviser, financial adviser, and financial planner. And it fits the expectations of most investors who use these people's services.

Representative's obligations. The representative accepts all of the duties listed above for the Self-Managed relationship, plus the following:

- make investment recommendations that are in the investor's best interest and conform to the Fair Dealing Document
- act as the investor's agent on behalf of the firm
- support recommendations with any information the investor needs to make an informed decision
- refrain from giving advice or executing transactions that favour the firm or representative at the expense of the client
- monitor the account for ongoing compliance with the Fair Dealing Document, and make any appropriate recommendations
- provide information in order to help the investor fulfill his or her decision-making role

One consequence of the first duty is that representatives may be obligated to refuse to execute inappropriate transactions suggested by clients. Current regulations allow representatives to avoid potential liability for the client's own choices by recording such trades as "unadvised" or "unsolicited" on the order ticket. There will be no equivalent to this practice under the Fair Dealing Model, which presumes that all Advisory account transactions have been "advised".

When unable to persuade a client to abandon the idea of an unsuitable trade, a representative can choose one of the following courses of action:

- Complete the trade, so long as it is consistent with the Fair Dealing Document. For example, a speculative trade may be consistent with a conservative portfolio, if the parties have allocated a small percentage of the portfolio to speculative investments.
- Modify the Fair Dealing Document – perhaps the risk tolerance section, or the portfolio allocation – so that the trade fits within its parameters. Both parties would need to sign off on the modifications.
- Open a separate Self-Managed account for the investor, or convert the existing account from Advisory to Self-Managed, so that the investor takes full responsibility for her trading decisions.

Investor's responsibilities. Investors in this category play a more complex role than they would in a Self-Managed relationship. Making investors aware of their responsibilities will help protect the firms that risk liability for inappropriate investment choices. Investors' obligations, which arise under the Fair Dealing Document, would include:

- recognize that they are ultimately responsible for making decisions
- inform their adviser if they do not understand a recommendation
- inform their adviser of any changes in their financial circumstances, needs, risk tolerances or investment goals
- review trade confirmations and account statements and raise any concerns as they arise

Investors who fail to meet these basic expectations will lose some of the protections they would have otherwise enjoyed.

Managed-For-You relationship

Where an investor is comfortable turning over complete management of an account to the adviser, and the adviser agrees to accept the most rigorous regulatory requirements, they should opt for the third type of relationship.

> ***In a Managed-For-You relationship, the investor relies completely on the adviser, who assumes a trustee-level fiduciary responsibility for all investment decisions.***

With this type of account, the adviser is given the discretion to make and implement decisions for the investor. The investor has no decision-making role for individual trades.

The adviser has a duty of utmost loyalty to the client, comparable to the fiduciary duty owed by a trustee to a beneficiary. The conduct standards expected in this situation are very clear. The Fair Dealing Model does not propose to supplement them with additional requirements.

This type of account exists in the marketplace, but currently it can only be offered by certain individuals and firms. Specifically, advisers who are registered as ICPMs (investment counsel/portfolio managers) or representatives employed by IDA member firms who have obtained a portfolio manager designation may offer this service. Individuals registered simply as salespersons or registered representatives are prohibited from exercising this type of discretion, regardless of their proficiency levels or their clients' wishes. And ICPMs are currently not allowed to work on a commission basis, even where the client prefers it. Typically the service is fee-based, and available only for investors with large accounts.

The Fair Dealing Model could offer more flexibility than the current rules allow.

Comment requested

Should we allow representatives who do not meet the current ICPM compensation or proficiency requirements to form Managed-For-You relationships under the Fair Dealing Model? Would this improve access and reduce costs for investors?

The following table summarizes some of the most important features of each relationship type. Many of the requirements shown in the table are not discussed until later in this paper.

Key characteristics of the three relationships

Relationship	**Self-Managed**	**Advisory**	**Managed-For-You**
Client's level of reliance on firm and representative	Execution services only	Decisions made in reliance on objective, expert advice	Complete reliance within agreed limits
Responsibility for decisions	Client	Both client and representative	Representative
How conflicts are managed	Compensation and any conflicts of interest are transparent Duty to act honestly and in good faith	Compensation and any conflicts of interest are transparent Duty to act honestly and in good faith Advice must not be biased by compensation	Trustee level fiduciary duty (precludes certain forms of compensation without specific consent)
Investor education responsibilities	No responsibility beyond providing basic information	Representative has role to support client decisions	Client only needs to understand services provided
Typical examples	On-line trading services Salespeople	Financial planners Investment advisers	Financial planners Portfolio managers

Avoiding relationship troubles

Representatives. On the preceding pages, we have described the minimum duties owed by each party. Generally, nothing would stop them from exceeding those thresholds and providing higher service levels, perhaps for business reasons. For example, a representative could offer Self-Managed clients additional information about investments, even though it is not required.

A potential problem arises, however, if a representative offers "advice" to a Self-Managed client. Whether by design or through carelessness, that representative would be providing the services typical of an Advisory relationship, after having agreed to the less rigorous regulatory requirements of a Self-Managed relationship. Or put another way, the investor might be encouraged to rely on advice without benefiting from the extra safeguards of a documented Advisory relationship.

What would deter representatives from engaging in this type of behaviour? And how do we know when the line is crossed?

The only way to create absolute certainty in this area would be for regulators to define what constitutes “advice”. We would then be regulating what representatives can and cannot say to clients. This leads to approved “scripts”, or potentially, the prohibition of certain forms of communication. Few market participants, or indeed regulators, want to see this happen.

The less intrusive regulatory alternative is to stay silent and allow the courts to resolve any disputes that arise. Where a representative in a purportedly Self-Managed relationship offers advice to clients, a judge may find that there was in effect an undocumented common law Advisory relationship. The court could then enforce the higher standard of care of the Advisory relationship, thereby increasing the firm’s exposure to liability for any trading losses. This risk should outweigh any perceived gain from avoiding the more stringent regulatory requirements of an Advisory relationship.

In litigation like this, a representative’s case would be weakened with the establishment of evidence like the following:

- he gave the client personalized recommendations
- he invited the client to rely on information he provided
- he undertook to analyze or comment on the client’s portfolio
- he is found to have flouted regulatory safeguards intended to control activity in the account
- the client actually relied on the advice

But the client would face an evidentiary burden to overcome the fact that she signed a contract agreeing to assess for herself, rather than rely on, any information provided. She would be required to argue that both she and the representative have done something that was not contemplated in their agreement – not the ideal starting point in litigation. In any event, she would need to demonstrate actual reliance. And she would have to prove negligence or breach of fiduciary duty on the part of the representative or firm.

Outcomes would always be uncertain for both sides due to the different fact patterns and evidence of each case. To avoid risks, a representative in a Self-Managed relationship must behave consistently with the expectations set out in the Fair Dealing Document. This means any information offered to the client must be impersonal in nature – that is, not tailored to the investor’s own situation. The representative can discuss investment opportunities and supply any information the client requests. But if pressed to provide advice, the prudent representative would explain the limits of the relationship type, and suggest a switch to an Advisory relationship. Alternatively, if a representative expects it will be difficult to avoid offering advice, he should steer clients towards an Advisory relationship from the outset.

A relationship-based model offers greater certainty for representatives who remain true to its principles, but little protection for those who try to test its limits.

Firms. In the type of scenario described above, the branch manager and the firm would face the possibility of regulatory action for inadequate supervision. (The representative, of course, would also be subject to disciplinary action.) The Fair Dealing Document offers firms a concrete means of verifying, for compliance purposes, what kind of agreements their representatives are making with clients.

An important expectation we would have of firms is that they do not create incentives for their representatives to behave in a manner inconsistent with the prescribed limits of the chosen relationship type. Inconsistent behaviour could include Self-Managed representatives giving advice, as well as Advisory representatives who let sales incentives impair the objectivity of their recommendations. We refer to inappropriate incentives from the firm as "structural conflicts", and discuss them in detail under the third of our Fair Dealing principles found later in Part III.

We will comment on one final scenario we expect to become increasingly common over the next few years. Technology now allows firms to offer their customers automated risk warnings, asset allocation advice, and other analytical tools. Does this constitute "advice" that should not be permitted in a Self-Managed relationship? We don't believe so. Clients who choose this relationship agree not to rely on the information. But the firm should ensure that expectations are clearly established in the Fair Dealing Document.

In presenting the Fair Dealing Model, we have learned that questions frequently arise about the mechanics of the three relationship types. We have provided the following Q&A to offer some practical guidance.

Q: Will it be possible for a representative and client to migrate from one relationship type to another?

A: Yes, but since this would result in a fundamental change in the relationship, you would need to agree to a new Fair Dealing Document to ensure both parties understand their new rights and responsibilities. (Please see the discussion in Part IV, Stage 3.)

Q: Can a representative and client be in two relationship types simultaneously?

A: It is possible for an Advisory and a Managed-For-You relationship to coexist, for example, where a portfolio management client maintains some discretion over a portion of her assets held in a separate account. However, while a representative in theory could act as a conduit for a Self-Managed account as well as operate an Advisory account with the same client, the representative would risk being held responsible for losses incurred in the Self-Managed account. The client could claim that she believed a trade was advised. While we would not prohibit this combination, we see practical difficulties with the same representative wearing two hats with the same client. The Self-Managed account would have to be formally established and separately tracked. It would not be sufficient to simply label some of the trades in the Advisory account as "Self-Managed".

Q: Will existing accounts need to be classified into one of the three relationship categories? Will providers need to create a Fair Dealing Document with their existing clients?

A: Yes, eventually. These steps can, however, be phased in around some reasonable implementation schedule. We do not expect that any existing accounts will have to be closed and reopened just to accommodate the new requirements.

Q: In any of the relationship types, would a financial services provider ever run afoul of the Fair Dealing Model for selling only its own proprietary investment products?

A: No. A key element of the business model of many firms is to offer a range of proprietary investment products that enable them to provide pooled portfolio management services to their clients cost effectively. We have no problem with this practice, assuming they comply with the basic principles of transparency and conflict management we describe later in Part III. Just as we do not expect a discretionary portfolio manager servicing high net worth clients to recommend a competitor's services, we would not necessarily expect a representative in an Advisory relationship to recommend third party funds when suitable proprietary investments are available.

Q: Will all representatives in Advisory relationships have to become fee-based financial planners?

A: No. Under our proposals, compensation methods would not be prescribed, but would be transparent. The potential for compensation to have an undue influence on advice is not confined to commission-based systems. We do propose, for debate, as one alternative, prohibiting third-party compensation paid by investment funds. If we were to do so, representatives would need to negotiate a new compensation arrangement with their clients, but it would not have to be fee-based. (See the section at the end of Part III titled "Special Case".)

Q: Can a representative in an Advisory relationship ever exercise discretionary authority over a client's portfolio?

A: Generally, an investor who wants discretionary management services should choose a Managed-For-You relationship. There may be circumstances, however, where an investor wishes to maintain the control of an Advisory relationship, yet still occasionally delegate discretionary trading authority to the representative. For example, the investor might delegate such authority, within set parameters, during a vacation.

Due to the safeguards applicable to Advisory relationships, we see no reason to interfere with the mutually convenient arrangements clients and representatives wish to make. (Similar flexibility is currently permitted for IDA member representatives.) This decision would need to be recorded in the Fair Dealing Document. If the discretion became too broad, the parties would need to recast the relationship as Managed-For-You.

Q: Will proficiency standards be tied to the relationship types?

A: No. Proficiency requirements would be based on the services offered. A representative must be proficient to provide the services the client has selected in the Fair Dealing Document. Thus, the proficiency standards required of a representative would be tied to services provided by that individual under the Fair Dealing Documents, not to the basic license. SROs like the IDA already use this type of system.

Licensing details will be covered in a second concept paper, but the general idea is that all individuals would obtain a basic financial services provider license, based on integrity, and either sponsorship by a registered firm with back office and compliance monitoring capabilities, or a relationship with an approved special purpose entity. This would entitle that person to form any of the three relationships provided they are proficient to perform the services contracted for in the Fair Dealing Document. Licenses will not be based on particular products or services. For example, an individual who wanted to form an Advisory relationship limited to stock selection would not be required to meet broad personal financial planning proficiency standards.

Fair dealing principles

Along with being relationship-based, the other fundamental characteristic of the Fair Dealing Model is that it is built on three core principles.

> ***To achieve fair dealing, our regulations must reflect three fundamental principles:***
>
> 1) ***There should be a clear allocation of responsibilities.***
> 2) ***All dealings with retail investors should be transparent.***
> 3) ***Any conflicts of interest should be managed to avoid self-serving outcomes.***

Defining core principles keeps us disciplined as regulators by ensuring that our rules are coherent and remain focused on the primary objectives. It also helps achieve certainty for market participants, who know that there will always be a consistent rationale underlying the regulations. In knowing the basic principles, they will be better able to predict how regulators would react to new situations that might arise.

These three principles seem obvious once they are stated, and some people might be surprised to learn that they do not already form the basis of our regulations. They emerged during the Fair Dealing Model Committee's discussion of the problems described in Part II of this paper. They reflect the best practices of the industry, as well as the expectations of sophisticated investors. They are also reflected in the way courts assess disputes between financial services providers and clients in both common law and civil law jurisdictions.

The core principles form the basis of the specific regulatory proposals we advance in Part IV. They apply differently to each relationship. For example, conflict management requirements in a Managed-For-You relationship are more rigorous than those applicable to a Self-Managed relationship.

We will now explore each principle more fully.

Principle #1: Clear allocation of responsibilities

As we described in Part II, our current regulations do not encourage financial services providers and their clients to clarify their key expectations for each other. The Fair Dealing Model aims to ensure they do so at the earliest possible stage.

The roles and responsibilities of the investor, the representative and the firm must be clearly established and documented when the relationship is formed.

We are concerned with two general categories of roles and responsibilities. The first is the duties prescribed by legislation or regulation, or extracted from court decisions. It is our job as regulators to ensure that these duties are clearly articulated, but as we described in Part II, there is considerable ambiguity in the current laws. The Fair Dealing Model would provide much more specific guidance in these areas.

The second category is the roles and responsibilities the parties agree to between themselves. For the representative, these are likely to include the level and type of services provided, account reporting and monitoring obligations, and fees and other costs. The investor needs to know what services to expect from the representative – and, more importantly, what not to expect. For example, a full service financial institution may market its abilities to provide comprehensive, personalized financial planning services – but an investor purchasing mutual funds at a branch should be aware that she is not going to receive that level of service. (This may be obvious to most customers, but not to all.)

Investors will also need to agree to certain responsibilities. These may include verifying that trading instructions were carried out, reviewing account statements, and providing updates on their financial status, personal circumstances and investment goals. Perhaps most importantly, investors agree to the level of reliance they place on the representative – a direct result of the relationship type chosen. All of the investor's roles and responsibilities are part of the second category, since regulatory requirements do not apply to customers.

We would consider responsibilities to be "clearly established and documented" if both the investor and the representative are aware of them, and document them plainly and concisely in a contract. It is important for each of them to understand both their own and the other party's responsibilities.

Benefits. There are a number of positive outcomes when all parties fully understand what is expected of them. First, better informed clients can achieve better investment outcomes. They are aware, for example, that they need to inform themselves about their investments, monitor what is happening in the account, play an active role in decisions, and keep the representative informed of any changes in their financial circumstances and investment needs.

From a customer satisfaction standpoint, investors are less likely to be disappointed with the services they receive if they have more realistic expectations from the outset. For similar reasons, full-blown disputes are less likely.[16]

---

16 One member of our Fair Dealing Model Committee recalled that as soon as his firm began recording all telephone conversations, 90 per cent of disputes could be resolved immediately because the firm could now verify what had transpired. Analogously, by documenting key roles and responsibilities, the Fair Dealing Document should reduce some types of disputes.

In the event disputes do arise, they will be easier to resolve. There is a clear contractual record of what each party was expected to do. If either of them deviates from their agreed role, a court or other adjudicator can turn to the contract for guidance. When the outcome of litigation is more certain, the party with the weaker position is more likely to settle or abandon the case. Representatives who provide the level of services they've promised are therefore better protected from frivolous claims.

How a clear allocation is achieved. The Fair Dealing Model seeks to achieve a clear allocation of responsibilities through two key events in the account opening process: selecting a relationship type, and completing a Fair Dealing Document.

Many of the responsibilities of both the representative and the investor are determined by the relationship they choose. Earlier in Part III, we listed the unique set of duties applicable to each party for each of the three relationships. Selecting a relationship type means selecting that set of duties. And we will mandate a selection process that should make these duties clear to both parties. Specifically, we will require the representative to explain fully each of the available options to the client before the choice is made. This is the first major step the parties undertake in completing the account opening contract known as the Fair Dealing Document.

The Fair Dealing Document serves a number of purposes. It establishes a process for the parties to make important decisions such as the relationship type; it documents these decisions; and it serves as a reference and educational tool. In addition to listing the prescribed duties of each party, it records other choices on matters like investment objectives, costs, and services provided. Choices like these are at the discretion of the parties, rather than the regulators. But these choices nevertheless shape the overall roles and responsibilities, and we believe it is essential to discuss and document them at the time the relationship is formed.

In summary, the Fair Dealing Model would establish a clear allocation of responsibilities by articulating consistent sets of rules, and by requiring the parties to actively discuss the available options and document their choices. We explain the account opening process in more detail at the beginning of Part IV.

We've devoted most of this discussion to the investor and the representative. But the implementation of the Fair Dealing Model should assist the other party to whom our first principle applies – the firm – in carrying out its own major responsibility. A key obligation of the firm has always been to supervise the activities of the representatives that deliver its services. The clear allocation and documentation of responsibilities should strengthen the hand of internal compliance departments in two ways. First, compliance staff will have a clear record, in the form of the Fair Dealing Document, of what a representative has agreed to do. They can cross-reference this with actual results. Second, the quality and precision of customer complaints they need to deal with should improve. This is a result of clients being more aware of account activities due to improved reporting (discussed in the Transparency section below), and the likelihood of many disputes being more easily resolved, as described above.

Principle #2: Transparency

The second of our three governing principles is that all dealings with retail investors should be transparent. Our definition of "transparency" goes beyond the traditional securities regulatory concept of disclosure.

> ***Transparency is disclosure that is understandable and meaningful to investors. Relevant information should be communicated at the time and in the manner most likely to be useful to the investor.***

Investors need to have access to all relevant information when they make investment decisions. No one would dispute this proposition. Our securities laws, however, assume that it can be achieved through disclosure alone. If you make available every item of potentially useful information, the reasoning goes, investors will somehow find what they need.

While it is important to ensure that comprehensive information is available, not every audience is equally well served by this approach. The most sophisticated investors depend on detailed disclosure, and are capable of finding what they need. But at the other end of the spectrum, many people can be overwhelmed by the sheer volume or complexity of typical disclosure documents. The likely response of this group is not to read anything at all.

Another transparency-related challenge is that certain useful information is not available at all, regardless of one's aptitude for sifting through documents. This is the opposite problem of disclosure overload, but in both cases, the result is effectively the same: investors are not getting the information that is important to them.

Just as a good regulatory model must reflect firms' modern business practices, it must also recognize some realities about the way individuals come to understand and use information.[17] For example:

- many retail investors have little or no investment knowledge
- most people cannot absorb information packaged as thick or text-heavy documents, or they find it difficult to extract the salient points
- people are less receptive to researching a decision after they have effectively made it
- many individuals are susceptible to considering the potential returns of an investment without properly taking account of its risks

To promote real transparency, the Fair Dealing Model would broaden the regulatory focus to consider not just *what* is communicated, but how and when and by whom.

---

17 Our analysis here is based on, among other sources, studies and literature reviews conducted on behalf of the Investor Education Fund established by the OSC. These include "Investor Information Document Usability Review", prepared by the Test of Workplace Essential Skills (TOWES) Joint Venture in May, 2002, and "Feasibility Analysis for Risk Tolerance Assessment and Risk Awareness Training for Consumer Investors", prepared by Industrial Mathematics Lab Inc. in December, 1997. See also Statistics Canada, "Literacy in the Information Age: Final Report of the International Adult Literacy Survey", 1994.

- **What is communicated**: Investors should receive the information that is most relevant to their decisions, in a form they can understand.
- **How**: The best communications medium is the one that is most accessible to its audience. Printed text may be most appropriate in some situations, while graphics, videos, or computer presentations may be better in others. Where text is used, it should be written in plain language. And wherever possible, information should be tailored to an investor's own situation, rather than presented as boilerplate disclosure, fine print, or hypothetical situations.
- **When**: Information should be provided at the time the investor is most likely to be interested in it. For example, investors will be most interested in information about a specific investment opportunity at the time they are making the decision rather than afterwards.
- **By whom**: Where possible, disclosure obligations should be placed on the source investors are most likely to look to for information. This will typically be the representative. As the investor's main contact, the person familiar with the investor's personal situation, and the one being paid to look after clients' needs, the representative is also in the best position to interpret the available information for the investor.[18]

These general concepts can be better understood in the context of four specific areas where we believe adequate transparency has not yet been achieved.

> ***The Fair Dealing Model would set standards for transparency in four key areas: the essential features of the investment, risk, compensation, and account performance.***

Essential features of the investment. Most investors could make more effective decisions if they had a better understanding of basic investment concepts. The Fair Dealing Model would require investment service providers to make an effort to explain the key features and investment considerations for each type of security a client might consider. The representative would be responsible for ensuring investors receive the information. (For details please see the discussion in Part IV titled "Other communications at the account opening stage".)

Risk transparency. Many investors fail to appreciate the risks they face, for a number of reasons. The messages they receive often de-emphasize the inherent uncertainty of investing, focusing instead on the desired result. Where risk information is available, it can be incomprehensible to the average person. Typically the information is not tailored to their own portfolio. In the absence of relevant and understandable information, many investors are unable to interpret their own investment returns in the context of the level of risk they've taken on. And they can be unduly surprised or dissatisfied when their performance falls below their expectations. Disagreement over intended risk levels is a frequent source of suitability disputes.

18 The United Kingdom, Australia and New Zealand all place specific disclosure requirements on advisers giving personal advice about investments. See Appendix F for more details.

Risk transparency is a recurring theme in the Fair Dealing Model. We would require different types of risk-related communications at three distinct points in time: general information at the time of account opening; security-specific risk assessment for each transaction; and ongoing assessment of portfolio risk with each account statement. We describe our specific proposals throughout Part IV.

This combination of general and personalized information about risk levels should leave investors better equipped than they currently are. Specifically, they should be better able to maintain balanced portfolios with risk levels they are comfortable with, and more prepared to weather inevitable market cycles. In the long term, therefore, an understanding of risk can help investors realize their ultimate long-term goal that their investment portfolio will be sufficient to meet their needs.

Compensation transparency. Compensation transparency is achieved when investors are aware of all the costs they incur for the investment services they receive. These costs may include up-front commissions, execution costs, third party compensation, incentives offered by the firm, and any other fees received either by the firm or the representative. Much of this information is currently provided in some form, but the quality of information can vary widely between firms and between different types of securities or services. In most cases, compensation information is provided only on a transaction by transaction basis. Many investors are therefore unaware of the total amount of compensation they are paying for retail services, or of its impact on their portfolios.

Like risk transparency, compensation transparency is a Fair Dealing Model concept that recurs at all three stages of the retail investment relationship. We would require firms to disclose all fee levels in advance when an account is opened. The disclosure for every transaction would include the actual compensation costs the investor incurred. And annual account statements would show the aggregate amounts paid over the year. We think that the amount actually paid is a more meaningful measure to most people than a generalized description of the amount one might expect to pay based on a hypothetical investment amount.

Compensation transparency can yield a number of positive results. Increased price competition is likely to result when fee levels are known and comparable. Investors can more readily determine whether they have received adequate value for the money they've spent. For example, they are better able to judge the performance of a mutual fund if, in addition to seeing performance statistics and reading the manager's discussion of past performance, they know the full amount they've paid for that performance. In contrast, a lack of transparency may impede the comparison of two ways of achieving a particular investment goal, such as buying bonds directly or obtaining an interest in bonds by investing in a bond mutual fund.

Finally, transparency is a key tool for managing compensation-related conflicts of interest. It enables investors to assess whether compensation has impacted a representative's investment recommendations. We return to this idea below in our discussion of our third core principle.

Account performance. We believe the account statements provided by most firms could do a much better job of reporting on clients' portfolio performance. In the preceding paragraphs, we mentioned that we would require account statements to include an analysis of portfolio risk, as well as aggregated costs of compensation. Another important analysis prescribed by the Fair Dealing Model is personalized performance information – a measure of the actual return earned by an investor. This measure goes a step beyond reporting a simple beginning and ending balance, in that it takes account of any funds the investor contributes or withdraws during the period. We outline our specific proposals in the section of Part IV entitled "Content of account statements".

This type of transparency offers investors the opportunity to better understand and monitor their progress, and if necessary, adjust their investment strategy.

Q: What if a client is unable to understand a particular concept? How far does a representative have to go?

A: Any time a client fails to grasp something, a representative in an Advisory relationship is taking a risk. This is especially true if the representative is recommending a sophisticated strategy. The best course of action in such a case is to keep recommendations as simple as possible. Representatives might also wish to document the steps they took to help the client understand concepts.

Q: What difference will transparency make to the segment of the population that cannot understand basic financial concepts?

A: In our view the average person could understand a whole lot more if it were explained properly. There is an element of mystification in much financial information. What the literacy and numeracy research studies show is that most people couldn't understand current disclosure material if faced with it – but not that the underlying ideas relevant to their interests are beyond them. Despite the fact that it has been shown that most appliance manuals are beyond the average person's literacy level, most people by trial and error eventually figure out how to run their DVD players and washing machines. We are not expecting clients to become experts and replace their advisers. But if clients are taking on responsibility for decision-making, it needs to be part of the representative's expertise to be able to make things clear so the clients understand what they are deciding.

Principle #3: Management of conflicts

The final Fair Dealing principle is that investment service providers should manage any conflicts of interest to avoid self-serving outcomes. As regulators, our goal is not to prohibit all situations that might lead to conflicts, but rather to establish clear standards that enable market participants to deal with them appropriately. We argued in Part II that too often the current regulations offer no meaningful guidance for representatives facing competing loyalties. Clear and effective rules on conflict management can simplify [things] for representatives and firms, and positively impact investors' confidence and trust.

The Fair Dealing Model focuses on two general categories of conflicts:

1) individual conflicts, based on the way representatives are compensated
2) structural conflicts, resulting from the way a firm is organized

Individual conflicts. An individual conflict arises whenever a representative has incentives that are unrelated to the best interests of the investor.[19] The incentives – which may benefit the representative, the firm, or a third party – need not be *opposed* to the investor's interests; it is sufficient that they make the representative indifferent. We regard such incentives as potential conflicts because of the reality that, for many representatives, compensation can drive behaviour.

Our definition of individual conflicts is admittedly very broad. It is broad enough to include, for example, commission payments, third party compensation (which we deal with separately below under the heading "Special Case"), and most sales-based rewards or pressures from employers. But while we cast a wide net in defining conflicts, the standards we propose for managing them are no more intrusive than the existing best practices.

The standard of conduct required to manage potential conflicts varies with the type of relationship chosen.

Like many of the Fair Dealing Model's conduct standards, conflict management requirements are designed to be appropriate for the relationship the investor and the representative have selected. A conflict of interest only exists when some kind of legal duty is owed to another person. The stronger the duties, the stricter the measures required to manage conflicts.

The conflict management requirements for each relationship type are summarized in the following table.

Relationship	Conflict management requirements
Self-Managed	Disclosure of all conflicts No misrepresentations
Advisory	Disclosure of all conflicts No misrepresentations Conflicts not permitted to influence advice
Managed-For-You	No conflicts permitted without client's informed consent

Transparency – described in the table as "disclosure of all conflicts" – is a key requirement for both the Self-Managed and Advisory relationships. Investors must, at a minimum, be aware of all direct and indirect incentives their representatives receive as a result of their account activity. Transparency imposes on representatives some natural discipline that might not exist if compensation were kept secret. Note that we already introduced compensation transparency

19 In *R. v. Kelly*, 73 C.C.C. (3d) 385 (1992), the Supreme Court of Canada said that "agents must not let their own personal interests conflict with the obligations owing to their principals. A conflict of interest exists when an agent is faced with a choice between an agent's personal interest and the agent's duty to the principal."

requirements to satisfy our second Fair Dealing principle. In that sense we are not adding a new rule here, just a further justification for an existing one.

It is our intention that the transparency requirement should apply only to real conflicts, rather than hypothetical ones. We want to educate investors about what might be motivating their representatives, without bombarding them with so much information they will disregard it all. Boilerplate disclosure of potential conflicts, such as a listing of a firm's underwriting relationships, is not relevant to an investor unless the conflict could actually affect the representative's advice. The onus will be on representatives to assess whether a potential conflict is applicable. They need to think about all the ways they are being rewarded for their services.

Another requirement shown in the table – "no misrepresentations" – is closely related to transparency, in that one means "Reveal the truth," while the other means "Don't be dishonest". But the rule against misrepresentations is more widely applicable because it applies generally, not just to potential conflicts. It should go without saying that representatives must be honest in their dealings with clients. We only draw attention to this requirement here to point out that conflict management is one of the purposes it serves.

In a Self-Managed relationship, we propose that a requirement for transparency and honesty is sufficient to manage conflicts. The reason is that Self-Managed investors agree to take full responsibility for decisions. They are expected to recognize that information they receive may be sales-oriented, and to assess its merits accordingly.

In contrast, Advisory investors rely on the representative to provide unbiased recommendations. For assurance that advice is motivated only by their own best interests, they need standards that are higher than transparency and honesty alone. After all, a representative could be completely candid about incentives, and still proceed to give recommendations that are driven by compensation. Therefore we add the requirement that representatives not allow their advice to be influenced by conflicts. Essentially this is a prohibition against biased advice. We articulate this requirement in Part IV, in the section titled "Obligations governing transaction advice and execution".

A Managed-For-You relationship is a fiduciary one, and therefore tolerates virtually no conflicts. Exceptions are made only where a conflicted transaction is disclosed and approved in advance by the investor. An example of a situation where an investor might want to grant consent is for a particular investment opportunity that pays a commission, such as an IPO. Without the consent, the adviser would have to account for such profits.

We do not consider that the asset-based fee typical of discretionary management accounts creates a conflict. With no reward to be gained for making particular trades or investments, the representative has no incentive to give self-serving advice. And, arguably, the interests of the parties are aligned, since fees increase in proportion to the investor's portfolio growth.

Conflicts arising from the structure of firms. A structural conflict occurs when a firm operates other business units that could benefit from its retail investment business. Structural conflicts arise primarily in full service firms – that is, financial institutions that offer services such as lending or investment banking, in addition to their retail brokerage or advisory services. Where a firm is involved in multiple businesses, there is a potential for its advice to retail clients to be self-serving. Clients seek investment advice to further their own financial goals, not the firm's.

Examples of structural conflicts include the following:

- The investment banking arm of a firm competes for business in part on its ability to distribute an offering through the firm's retail channel. Retail representatives seen by their firm's management as part of an integrated distribution system may be pressured or offered extra financial incentives to recommend such offerings to their clients.
- Investors may be encouraged to borrow in order to invest more. If the dealer is also the lender through a margin account, it earns income both through the loan interest and, most likely, commissions and other fees related to the extra funds invested.
- A firm may engage in principal trading, such as selling a client securities that it holds in inventory. The client may assume that the representative is acting as her agent, seeking the best price for her, when in fact the firm is also acting as principal – with quite the opposite incentive.

All of these conflicts can be managed through adherence to the following requirement.

> ***Firms must insulate their retail investment business by treating their other businesses as separate and at arm's length, and by extending them no preferential treatment.***

This means a firm could not rely on its retail distribution network to favour its investment banking, lending, or other business units. It would have to treat the retail business as it would any other arm's length customer – in other words, the firm would have to earn a sale, not expect it.

There is no need to bar firms from using their retail channel. Indeed, many clients of full service dealers are highly interested in products originating in the firms' investment banking units. The table on the next page demonstrates how a firm might comply with the requirement, using the example of a typical investment banking transaction – e.g. an IPO or secondary offering – in which the firm hopes to distribute securities through its own representatives.

Managing structural conflicts for a typical investment banking transaction

Acceptable firm conduct	Unacceptable firm conduct
Encourage representatives to consider this investment for their clients	Offer extra incentives (such as a 4% sales commission in place of the usual 2%)
Try to sell or persuade representatives on the merits of the investment	Establish sales quotas or targets for representatives
Provide representatives information about the security	Pressure branch managers to move the product

Similar conduct standards would apply to other types of structural conflicts. For example:

- Representatives could recommend their own firm's proprietary mutual funds or wrap accounts ahead of external products. But the firm could not offer differential incentives to encourage the representatives to do so.
- Principal trading would be acceptable, as long the firm is able to meet all the duties it owes as the client's agent.
- Any margin lending would have to be appropriate for the investor's portfolio and objectives.

In each of the above examples, firms would be allowed to access their retail channels without exposing their clients to the potential conflicts.

While this principle is intended to protect investors, representatives could also benefit. We received comments from advisers on the Fair Dealing Model website indicating that they have felt pressure to meet certain of their firms' sales targets. These individuals indicated that they would support any requirements that helped them keep their advice objective. (A summary of the comments we received can be found in Appendix G.)

Comment requested

Are there alternative means of preventing or managing structural conflicts?

Special Case: Third-party compensation

The payment of incentives to firms and their representatives by third parties warrants special treatment under the Fair Dealing Model. In particular, we are concerned about investment funds that compensate selling dealers through back-end loads, and trailing fees that are embedded in the fund's structure.

Back-end load funds typically pay the dealer a four or five per cent commission at the time of sale. Trailing fees, which are common with both load and no-load funds, can range from 0.25%

to 1.0% annually for each quarter the dealer's clients continue to hold a fund. In both cases the fund management companies make the actual payments to the dealer. But the true source of this money is the investor, through the management fees they pay out of their share of the fund assets each year, and through redemption fees if they sell back-end load funds within the first few years.

These incentives raise concerns related to all three of the fair dealing principles:

- **Clear allocation of responsibilities**: Determining the nature of the relationship between the investor, the representative and the fund management company becomes complicated. The client who relies on advice has no control over the amount her representative is paid. On whose behalf is the representative acting when the fund manager both sets the payment level and makes the payment?
- **Transparency**: Compensation details are typically available only within a bulky prospectus. And even investors who access the information may find it daunting to determine what they are actually paying due to the complexity of the calculation. (See, for example, Case Study #2 in Appendix F.) As a result, investors likely find it difficult to measure possible compensation biases, and assess the value they are getting for the fees they are ultimately paying.
- **Conflict management**: A key requirement arising from our third core principle is that Advisory account representatives must not be influenced by any conflicts. But these incentives are designed specifically to influence which investments representatives recommend. This conflict puts representatives in a difficult position, as the reward system threatens their objectivity.

The case studies in Appendix F use publicly available data to illustrate how specific third-party compensation schemes may have created biases.

Because of the unique set of difficulties posed by third-party compensation, we believe special measures may be necessary.

We are considering three possible approaches to address conflicts arising from third-party compensation:

1) ***Enhance transparency***
2) ***Place clear responsibility for the actions of representatives on a third party who compensates them***
3) ***Require that compensation be paid directly by an investor rather than through third parties***

For the reasons described above, these three approaches would apply to trailing fees and back-end loads, as well as wrap accounts holding external funds that offer these payments. They would not apply to front-end loads, which are transparent and are not paid out of the investor's share of the fund's assets.

Each of the three approaches is explained below. We also had a look at the U.S. solution of implementing ceilings or prohibitions on particular aspects of third-party compensation. We rejected this approach because it is onerous and expensive to administer, and yet it does not completely address the underlying conflict. All of these approaches are presented in more detail in Appendix F.

1) Enhanced transparency. This approach is essentially the same as our proposal above in the "Conflict management" section. That is, we would require representatives to disclose all compensation fully, make no misrepresentations, and for Advisory accounts, not allow themselves to be influenced by the compensation. Some people may believe that these measures alone are sufficient to address the problems.

These basic requirements will apply even if one of the other two approaches is also chosen. It is the minimum solution necessary to achieve fair dealing.

2) Make the third party responsible. Fund management companies pay dealers sales compensation out of management fees paid by investors – ultimately, out of investors' assets – that are usually portrayed as being expended for expert advice and client services. We believe it is at least arguable that the fund company has a moral obligation, if not a legal obligation as a fiduciary, to ensure the investors receive value for their money. Our second approach is therefore to make the fund company legally responsible for the actions of the dealer firm and representatives. The idea is to make the third party accountable for any harm that results from practices designed to influence the behaviour of representatives known to have conflicting duties to their own clients. Wronged investors would gain another recourse.

To elaborate, we would deem fund companies who pay third-party compensation to be vicariously liable for any losses due to the negligence, breach of fiduciary duty or fraud of the individuals who receive the compensation. There is some precedent in British Columbia case law to the idea of vicarious liability for acts of an insurance sales representative.[20] The legal means of achieving this result would likely be the creation of a statutory cause of action. This would be similar to the statutory right of action under the *Securities Act* that allows investors to sue issuers and underwriters for misrepresentations in a prospectus, whether they relied on it or not.

Fund management companies could simply decide to accept the risk and occasional liability for representatives' actions as a cost of doing business, as the dealers who employ them now do. Or they could set their own standards for dealers (such as supervisory practices) or individuals (such as proficiency requirements) they permit to sell their funds.

3) Require compensation to be paid directly. The third approach is an outright prohibition on fund management companies paying sales incentives to third party distributors out of fund assets. Representatives and firms would have to bill clients directly for the services they provide. The parties would remain free to choose the method of compensation.

20 See *Thiessen v. Mutual Life Assurance Co. of Canada* (2001 B.C.J. No. 1849)

This approach would address all of our concerns with third-party compensation. It would remove a significant source of compensation bias. There would be no question of whose interests representatives serve, and their relationship with their clients would become much clearer. Investors would know exactly how much they are paying.

Mandating this change – whether done quickly or in stages – should not prejudice any particular market participants. Fund management companies would not lose any competitive advantage as they would if they moved unilaterally to stop paying trailing fees. Similarly, no representatives would find themselves in a situation where they are alone in beginning to bill clients directly. And consumer acceptance would be facilitated if the entire industry moved to the new system at once.

Still, we recognize that there would be significant transition issues. Dealer firms and representatives would have to determine the best way to charge for their services and communicate the change to their clients. They would also incur a new burden of collecting fees from clients. Fund companies, on the other hand, would be able to eliminate the major cost of administering a complex compensation system, and of making it transparent as required by the Fair Dealing Model.

We are establishing Working Groups of industry participants to consider issues like these and to assist us with other implementation details. The Working Groups are described in Part V of this paper. Appendix F discusses in greater detail the rationale for a possible prohibition of third-party compensation and related practical matters.

Comment requested

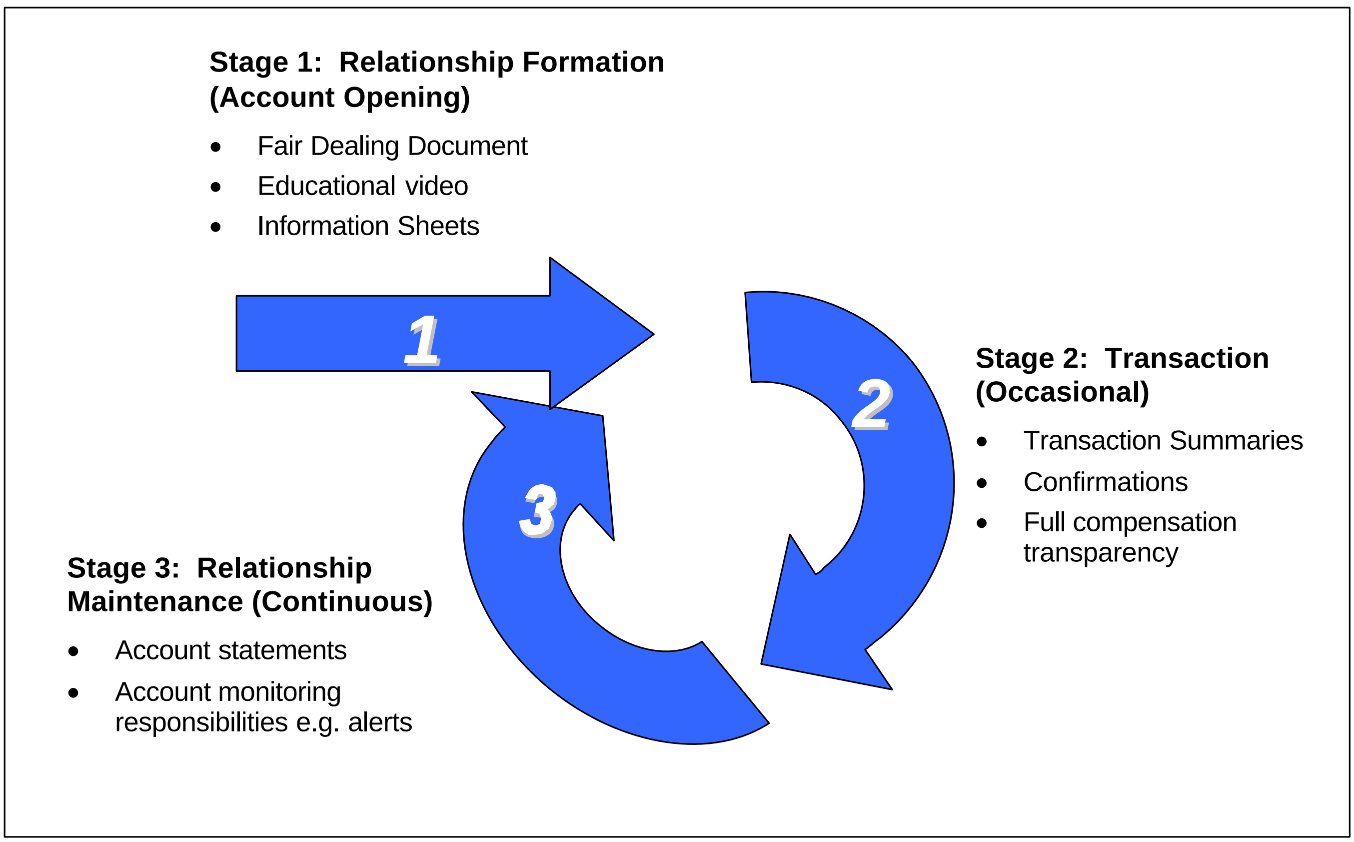
What is the best approach to address the problems we've identified regarding third-party compensation?

IV. Practical Details: How the Model Would Work

How might the broad principles introduced in Part III be applied as actual regulatory requirements? Part IV describes how a financial services provider's day-to-day business activities might be affected by the implementation of the Fair Dealing Model. We provide details – at as practical and specific a level as we can at this stage – of the proposed new responsibilities. Many existing standards and practices would be unaffected by the Fair Dealing Model, so we focus on what would change.

Part IV is organized in three sections, corresponding to the three stages common in some form to all retail investment relationships: account opening, a transaction, and relationship maintenance. The Fair Dealing Model does not mandate these stages, but recognizes that the principles and relationships underlying the model play out in different ways at each stage. We have organized Part IV in this way to better illustrate the model.

Tracking the Fair Dealing Model through the three stages of a relationship



Stage 1: Account Opening

One of the basic tenets of the Fair Dealing Model is that investors and financial services providers should reach a common understanding of their respective roles and responsibilities when the account is opened.

There are a number of advantages to formally establishing and documenting the expectations of both parties up front. Service levels and compensation would be more transparent. Both investors and financial services providers would be required to formally acknowledge the level of responsibility each will assume for investment choices. Having agreed to these and other matters at the outset, either side would find it more difficult to dispute them afterwards. Firms and representatives will find the applicable conduct standards on a given account easier to establish, and firms will find compliance with them easier to monitor.

In our view, one of the most significant innovations of the Fair Dealing Model is forcing people to define their relationship at the outset, rather than waiting until a dispute arises. Where there is a dispute, courts will attempt to reconstruct the relationship whether or not the parties have gone through the exercise.

We've divided our discussion of the account opening stage into three main topics:

1) the requirement to choose a relationship type
2) the requirement to create a Fair Dealing Document as the tool for documenting the choices made
3) other communications at the account opening stage

Choosing the relationship type

In Part III, we described the three types of relationship the Fair Dealing Model would recognize: Self-Managed, Advisory, and Managed-For-You.[21] It is crucial to make an informed choice of relationship type, as that decision will determine which set of legal requirements applies. It is also important to make the choice before any advice is given or allocation of assets is contemplated, as the nature of the relationship determines the scope of each party's responsibility for the outcome.

> ***At the account opening stage, all investors must choose one of the three relationship types: Self-Managed, Advisory, or Managed-For-You. The consequences of the choice must be made clear to the investor.***

21 Here we focus only on the process of selecting the appropriate relationship. Please refer to Part III for a detailed description of each relationship type.

We expect that the choice of relationship might be affected by the following factors:

- **Investor's needs**: The most important consideration will always be the needs and circumstances of each investor. What types of services does the investor want? How sophisticated is his investment knowledge? What kind of advice is he interested in? How much responsibility is he willing to take on for his investment decisions? Firms will continue to offer the services their clients demand.
- **Business model**: We would not require firms to offer any particular level of service, or enter any relationship they do not wish to enter. But we would require them to be open and clear about the implications of what they do offer. If it is not economical for a firm to enter into a Managed-For-You relationship with an investor with a $10,000 portfolio, the investor should know this. Similarly, if a client in an Advisory relationship will have access to expert systems for investing or predetermined unbundled advice, but he is not going to receive much personalized advice and attention, he should be aware of this.
- **Certain constraints** may preclude some types of relationship. For example, a firm may offer only Self-Managed accounts (e.g. a discount brokerage) or Managed-For-You accounts (e.g. a portfolio manager). A particular representative may not have the proficiency to offer certain kinds of services.

We will not mandate any specific procedures, dialogue or criteria designed to determine which relationship is optimal. The parties will always be free to make any choice that suits them. In practice, the preferred relationship may become obvious in the normal course of an initial client meeting. If it is not obvious, we would expect the representative to make an effort to inform the investor of the available options, either through discussion or some other means such as a video or interactive demo. (Please see the "Investor education requirements" section below.) We would place the onus on the representative to demonstrate that the investor has had an opportunity to make an informed decision.

The choice of relationship type determines the general legal framework that applies. Many other details are left for the parties to agree upon in the Fair Dealing Document, discussed below.

Creating a Fair Dealing Document

Once the parties have worked through the choices and agreed on a relationship type, they can begin to record this and other decisions they are making about the account.

> ***For every account opened, the investor and the representative must sign a Fair Dealing Document that documents the relationship type, investment objectives, and services they have agreed upon.***

In Appendix A, we've included sample Fair Dealing Documents for each of the three relationship types. Here we provide more details on the purpose of the document, our proposed content requirements, and practical issues in completing it.

Purpose of the document. The Fair Dealing Document is a legal contract that commits each party to an agreed set of responsibilities. It serves as an important guide both in the normal course of the relationship and in the event of any future disputes. Therefore, it is well worth the effort to be thorough in preparing it.

The Fair Dealing Document is also intended to communicate important information to each party. It helps the investor to understand the services he can expect to receive, the cost of those services, the nature of his relationship with the representative and the firm, and his own role in that relationship. As a reference document for the client it also has education value. And in Advisory and Managed-For-You relationships, the Fair Dealing Document would record information about the financial needs, goals and risk preferences of the investor, providing a foundation on which the representative can base recommendations and investment decisions.

The Fair Dealing Document could replace or consolidate existing account-opening documentation such as the know your client form, margin agreements (for clients who will be borrowing to invest), shareholder communication disclosure, and statements of policies concerning conflicts of interest. It would also serve the function of the investment policy statements used by some firms. We anticipate that the savings from eliminating these existing forms would partially offset the cost of providing the new document.

While the Fair Dealing Document may represent a significant change in the way some firms do business, that is not its purpose. Our intention is to create a more formal framework for the kind of dialogue that already takes place, or should be taking place, when investors open accounts. For example, some initial meetings likely already include a discussion of investment objectives and the services offered and desired, but others do not, or do so only superficially. The requirement to complete a Fair Dealing Document should ensure that the parties reach a common understanding on a number of specific topics, and that this agreement is documented for later reference. [22]

Required content. Our proposed content requirements for the Fair Dealing Document are summarized in the table on the next page. (For a more complete understanding, please read the table in conjunction with the samples in Appendix A.) The descriptions in the table and the samples in Appendix A should be viewed as minimum standards and illustrations, not as prescribed versions. Provided the document meets the minimum standards, the parties would be free to vary the wording or to include additional content.

We based our proposed requirements on a variety of sources. We tried to include any information that would be useful for investors who want to fully understand the relationship they are entering. We drew from industry best practices evident in some sample account opening documents. We considered the types of information – often left undocumented – that courts tend to look for in resolving disputes.

22 For example, completing and maintaining the Fair Dealing Document for each client would be consistent with Practice Standards 100, 200 and 300 proposed by the Financial Planners Standards Council in September 2003 for all individuals with Certified Financial Planner designations, regardless of their firm's account procedures. These are intended to be mandatory from Spring 2005 forward.

Proposed content requirements of the Fair Dealing Document

Content	Comment
Purpose of the document	
General information about the financial services provider	Introduction to the business entity as a whole, including the nature of its relationships with collective investment vehicles, and its use of proprietary products.
Description of the relationship type selected	Information on the fees applicable to each relationship type must be made available.
Representative's name and contact information	
Adviser's qualifications and available services	Not required for Self-Managed accounts.
Services provided by the firm	A comprehensive, prescribed list of financial services, with an indication of which are available. Helps inform investor of services only available elsewhere.
Manner of compensation	A comprehensive list of compensation methods, with an indication of which one(s) are available. Helps inform investor of compensation methods that may be available elsewhere.
Fee schedule	List of all fees to be paid directly by the investor. Must note the existence of any fees paid by third parties.
Investor's identifying information	
"Know your client" information	(Please see the discussion that follows this table.) Not applicable to Self-Managed accounts.
Investment policy for the account	Description of investment objectives, initial asset allocation, risk tolerance, etc. Helps ensure an initial meeting of the minds on a frequent topic of later dispute. Not applicable for Self-Managed accounts.
Investor's preferences for receiving annual reports and shareholder meeting materials	Substantially shortens the disclosure currently provided to investors by asking them the essential questions about the receipt of materials without describing the legal background.
Summary of the representative's responsibilities	Contents would vary significantly among the three relationship types.
Summary of the investor's responsibilities	Contents would vary significantly among the three relationship types.
Information Sheets desired by the investor	Described below, under the heading "Other communications at the account opening stage".
Complaint procedure and contact information	Investors should be invited to raise any complaints or concerns at the Branch Manager level or higher.
Signatures of both the investor and the representative	If completed online, electronic confirmation is sufficient.

Both the investor and the financial services provider would be responsible for keeping the information in the document current. We describe this process in our discussion of Stage 3, under the heading "Updating the Fair Dealing Document".

The "know your client" information item in the table warrants more detailed discussion. As mentioned earlier, the Fair Dealing Document would replace the current KYC form, providing a base for the Fair Dealing Model's portfolio-oriented approach to suitability issues. Through a series of specific questions on the investor's financial needs, income, assets, investing experience, risk tolerance, and other matters, it would also raise the minimum standard of relevant account information compared to the existing KYC requirement. This section is designed to reduce the incidence of both misunderstandings and unsuitable recommendations.

An investor would be entitled to choose not to provide certain information. For example, he might be looking to a particular representative to help only in selecting stocks using a small portion of his assets, without any intention that the representative would have an understanding of his overall financial goals. Such an investor could not later claim that the representative should have taken the omitted information into account in making recommendations.

A representative would also be permitted to leave out certain material if, in her judgement, it is clearly immaterial. Furthermore, representatives would have the option to use alternative means of evaluating an investor's risk tolerance, such as a risk evaluation questionnaire or informal conversations, rather than the questions we've listed in Appendix A.

The know-your-client information is not required in the Fair Dealing Document for a Self-Managed investor.

How to complete the document. The Fair Dealing Document is not designed to be a standard, boilerplate agreement. That is, it should not be merely handed to an investor with instructions to "please sign here". It should be completed interactively, with the investor encouraged to participate in the process.

We would expect firms to take reasonable steps to give their clients an opportunity to read and understand the contents of document. In a person-to-person situation, the representative should walk clients through each section, and explain the implications of any available choices. Even if economics or business models were to dictate that every client receives a nearly identical agreement, the representative would still be required to review it with each client in some detail. Where an investor is opening an account online, there usually is no opportunity for human interaction. Still, the Fair Dealing Document can be assembled interactively – for example, through a series of multiple choice questions.

In practice, even a customized document would likely be an amalgam of numerous previously drafted sections. It would be possible for firms to create computer-based templates that allow real-time "assembly" during a meeting. Check-boxes could also be used as a means of selecting from a list of common options. Nothing would prevent the parties from modifying existing language or adding new provisions to reflect individual circumstances.

Ideally, certain formatting details should be standardized across the industry to ensure that key information is presented clearly and prominently. This would also facilitate comparisons among financial services providers by allowing investors to easily see what options are available for various services and methods of compensation. In order to minimise the cost for small firms or individual representatives, the OSC intends to create and make available at no charge a sample Fair Dealing Document, to which a logo could be added or other modifications made.

Q: Is it true that the Fair Dealing Document is 14 pages long?

A: No. There have been a number of references in the media to a 14-page account opening document, attributed to various industry sources. In fact, the sample Fair Dealing Documents that can be printed from the website range from 4 to 8 pages, depending on the relationship chosen. The website also contains "roadmap" documents that give background information on the Fair Dealing Document for each relationship, but these are not the versions a client would see. Some account opening material we have seen is well in excess of 14 pages; much of this content is boilerplate legal language or marketing material, and not specifically driven by regulatory requirements. The Fair Dealing Document format should make some of this content unnecessary.

You can view three samples in Appendix A.

Q: Would the individual who is providing the services have to complete the Fair Dealing Document with the customer?

A: The Fair Dealing Document is a contract binding on the firm and the client. The financial services provider would be expected to ensure that whoever took the client through the agreement was capable of explaining what the client needed to understand, and, if executing the agreement as the firm's representative, was authorized to commit the firm to a particular Fair Dealing Document. However, unless the clients were contracting for the services of a particular individual, it would not be necessary that the persons(s) actually providing the services complete the agreement with the client, although they would have to be identified. If a team or special unit were providing the services, the team members, or the team composition if no one was specifically assigned to the client's account, would have to be identified.

Q: Other than the client, who are the parties to the Fair Dealing Document?

A: The simplest case is where a firm is organized as a corporation, with representatives acting on its behalf. Here, a client would form an agency relationship with the firm under the Fair Dealing Document, with services to be delivered on-line or by one or more representatives. The representative would be responsible for managing the client's account, but the firm would be vicariously liable for its representative's actions, and would have a direct duty of care to the client – i.e. its own supervisory and other activities not performed by the representative.

The answer is more complex where the same individual provides some services in her capacity as a representative for a firm, and other services to the same client directly as principal. An example of this might be a "financial planning" business that is incorporated by an individual selling mutual funds on behalf of a firm, and directly providing some Advisory relationship services listed in the Fair Dealing Document. In this case, the client may actually have to form a patchwork of contractual relationships, some with the individual directly as principal, and some with a firm through the same individual as its representative. From a policy standpoint, we want the client to have a simple, seamless contract for services that reflects their reasonable perceptions of who they're dealing with.

This complex situation would become much simpler as a result of ideas we will develop in our second concept paper (described in Part V of this paper).

Other communications at the account opening stage

The Fair Dealing Document is a contract that is also intended to communicate essential information. But since different people absorb information in different ways, effective investor communications should go beyond a printed contract. We would encourage (but not require) financial services providers to communicate with their clients using a variety of techniques, ranging from informal conversations to more technologically advanced methods. As for actual requirements, we would mandate two specific educational tools at the account opening stage: a video explaining the basics of securities investing, and a series of "Information Sheets" covering a range of topics.

Educational video or interactive demonstration. The Fair Dealing Model would require investors to make some important choices very early in their relationship. It follows that they could use some additional support to help them make the choices that are right for them, and to help them understand the responsibilities they are taking on.

> ***Prior to completing the Fair Dealing Document, every investor must have an opportunity to view a brief educational video (or equivalent) about the basics of securities investing and the choices available to them under the Fair Dealing Model.***

"Equivalents" to a video could include a DVD, CD-ROM, web presentation, or something similar. All share the advantage of presenting information in a format that many people can absorb more readily than pages of printed text. To minimize costs for financial services providers and to ensure consistency of content, a video or interactive demonstration could be produced and made available for this purpose by the OSC, or by a self-regulatory organization such as the IDA.

Representatives could also deliver the information orally, but at the risk of losing the benefits of consistency. They could be exposing themselves and their firms to liability if the client claims the minimum standards for the process were not met. To reduce this exposure, firms might resort to compliance monitoring practices such as taping initial client interviews. If every investor hears the same key messages (as they would with a video), firms can be more confident that they have satisfied the regulatory requirements.

Naturally, investors who have been exposed to this process once would not be expected to go through it every time they open an account if they do not choose to do so.

Information Sheets. A series of concise summaries, each covering a particular topic, would pick up where the video leaves off.

> ***An Information Sheet is a standardized description of a particular type of security, or of investing in general, that would be distributed to an investor prior to his first transaction.***

We are proposing two types of Information Sheets: a general “Securities Information Sheet”, and a series of specific Information Sheets each describing a single type of security. We have included several samples in Appendix B.

The Securities Information Sheet would broadly cover topics like the taxation of investments, borrowing to invest, and the various types of risk. Improved risk transparency – like improved compensation transparency – is a recurring theme of the Fair Dealing Model. We believe it is essential to begin educating investors about risk at the account opening stage, a time when they are agreeing on their investment objectives and asset allocations. The Securities Information Sheet would attempt to make all investors aware of the types of investment risk (i.e. market risk, individual security risk, portfolio risk, foreign exchange and political risk, reinvestment risk, and intermediary risk), and the concept of needs risk (uncertainty over their own future needs, such as how much money is needed after retirement).

The other Information Sheets cover specific types of securities. Depending on the transaction services or investment recommendations it offers, a firm would produce separate Information Sheets for equity, bonds, income trusts, mutual funds, exchange traded funds, wrap accounts, limited partnerships, options, etc. Each Information Sheet would describe what the security is, how retail investors buy and sell it, the nature of the market for the security, how retail investors compensate their financial services providers, and risk considerations relevant to the particular security. Investors would only receive these specific Information Sheets for the types of securities they might consider holding.

Investors must have an opportunity to review all of the relevant Information Sheets prior to completing their first transaction – even where the account is opened and the first transaction is completed at the same meeting. Information Sheets would not be required again, but would remain available by request. Firms might wish to integrate the prescribed content of Information Sheets with their own investor education and promotional materials, but it would have to be separately identifiable.

In Advisory relationships, investors would be responsible for informing the financial services provider if they don’t understand the material. In Self-Managed relationships, since investors are not looking for any advice or expertise on securities, how they handle the information provided is up to them.

Stage 2: The Transaction

The transaction stage includes any advice leading up to a trade, its execution, and relevant communications before and after the trade.

We have stated that, unlike the current regulatory model, the Fair Dealing Model is not product-based or transaction-based. Nevertheless, the model’s success in realizing the principles we described in Part III will ultimately be measured by how well it performs each time an investor makes a trade or has a trade made on their behalf.

We've divided the discussion of the transaction stage into four major sections, corresponding to our major proposals. Those proposals would require financial services providers to do the following:

- meet certain standards governing advice and execution of transactions
- provide investors specific documentation before and after each transaction
- fully disclose all compensation received
- communicate the risk level of each security

Obligations governing transaction advice and execution

The Fair Dealing Model would impose certain minimum standards on the conduct of firms and representatives during the transaction stage. Most of what follows applies to Advisory relationships only. (The trustee-level fiduciary duties of a Managed-For-You relationship are already as high or higher than the standards we mention here, and there is no transaction advice required in a Self-Managed relationship.)

Increased responsibilities for representatives. As we discussed in Part III, transparency is best achieved when investors have access to relevant information, at the time they are most likely to be interested in it, read it and absorb it.[23] In an Advisory relationship, it is representatives who are ideally positioned to provide this information. Not only are they in direct contact with investors at the time trading decisions are made, but delivery of relevant advice and information is central to their role in the relationship. In contrast, disclosure documents mass-produced by third parties tend to be lengthy, often include many pages of information on securities the investor is not interested in, and cannot be tailored to an investor's own circumstances or level of sophistication.

The Fair Dealing Model proposes to articulate more detailed conduct standards for representatives.

> ***Representatives in Advisory relationships would take on greater responsibility at the point of sale for informing investors, and for assessing and interpreting information they provide to their clients, including information received from third parties.***

This obligation would lead to several results. The first is that representatives (or in practice, more likely their firms[24]) would be required to generate more transaction-related documentation in-house. This documentation, combined with the representative's own communications, would

23 The Financial Services Authority supports this view in "Consultation Paper 170: Informing consumers: product disclosure at the point of sale" (Feb. 2003), http://www.fsa.gov.uk/pubs/cp/cp170.pdf, p. 52.

24 While we characterize these obligations as those of the representative, in reality the firm maintains its overall responsibility for its representatives' actions. The Fair Dealing Document is a contract between the investor and the firm.

play a key investor education role. We describe these new content requirements later in this section.

Another result is that representatives would be expected to take a more active role in assessing and explaining issuer information, rather than simply supplying documentation, such as prospectuses or annual information forms, produced by issuers. Investors are more likely to rely on advice given to them personally and directly, so we would hold representatives accountable for it. For example, representatives would be expected to filter and independently assess issuer-generated information or third-party research to support investment recommendations.

Implications for Investment Funds. Defining a clearer role for Advisory representatives in supporting investor education, together with the Fair Dealing Model's general focus on transparency rather than disclosure, would support a related idea. We could dispense with the current requirement for investment funds to deliver a prospectus subsequent to the purchase of units. Instead, fund managers could make more concise, relevant information about their funds available for distribution by dealers at the point of sale. Fund managers would be responsible for the accuracy of this material. Dealers and their representatives would be responsible for distributing this information to their clients, and for any supplementary information they chose to include.[25]

This approach fits the principles of Fair Dealing more closely. It achieves better transparency about the implications of the investment, and supports the management of conflicts of interest at the representative level. It allocates some of the responsibility to the representative who communicates directly with the investor, rather than imposing the entire obligation on the fund manager who lacks such contact. This allocation is appropriate because the representative is in the best position to compile the complete set of information that is really relevant to an investor before they choose a mutual fund. In particular, investors need to know both the background and investment philosophy of the fund and its manager (available from the fund manager), and the total cost to the investor (available from the firm).

Dispensing with prospectus delivery would be consistent with the Consultation Paper released by the Joint Forum of Financial Market Regulators in February, 2003.[26] We discuss that paper and our own proposals at greater length below under the heading "Mutual fund disclosure obligations", in the section titled "Information provided to investors".

25 For operating businesses, the prospectus is used for providing the market with complete and accurate disclosure about the issuer's business and financial position and the terms of the financing, with a view to setting a market price. A mutual fund prospectus documents the expectations of a long term discretionary investment relationship with a portfolio manager, mediated through primary contact with the Advisory representative. It has a fundamentally different role. While an investment fund has the form of an "issuer" of securities, in substance it is itself a vehicle for delivering discretionary investment advice, on an impersonal, aggregate basis for many small accounts. The investor in an Advisory relationship is receiving "advice about advice", for which the representative is compensated. We believe the current requirement to provide a full prospectus to all mutual fund purchasers after the investment is made does not achieve transparency about the implications of the investment, or support the management of conflicts at the representative level

26 See Consultation Paper 81-403, "Rethinking Point of Sale Disclosure for Segregated Funds and Mutual Funds," prepared jointly by the Canadian Securities Administrators and the Canadian Council of Insurance Regulators (available on the OSC website).

More generally, we also note a key similarity – and a key difference – between the Fair Dealing Model and the Financial Services Authority's approach to transaction advice. Since 1998, the U.K. regulator has also mandated increased point of sale disclosure, requiring advisers to provide investors with a "Key Facts Document" (KFD) when selling mutual funds and other packaged products. But the FSA recently concluded that the KFD has been unsuccessful as a consumer information document, largely because investors have been insufficiently motivated to read it.[27] The FSA's proposed solution is to prescribe more specifically the content and form of the KFD, and to require advisers to draw investors' attention to the document. In other words, the FSA would continue to emphasize written documentation as the key vehicle for educating investors, while we are proposing to rely more on the expertise of the representative. The Fair Dealing Model contemplates that representatives will do what their clients are paying them to do.

Representatives' duty of care. The basic standard of care is well established for advisers to avoid claims of negligence or fraudulent misrepresentation.

> ***Having undertaken to advise someone, a representative has a general duty to advise carefully, fully, honestly, and in good faith.***

This principle has been articulated in common law, as well as in the *Securities Act* and the rules of some self-regulatory organizations. We do not propose to change this principle, but rather to reflect it more broadly and to clarify its application in areas of uncertainty. In particular, a few specific aspects of the advice given at the transaction stage would be affected.

- **Diligence**: How much work is a representative expected to do for each trade to determine if it is appropriate for the investor? We will not prescribe a formula or checklist to answer this question. Representatives will need to rely on their judgment and expertise, and most importantly, the expectations and portfolio parameters set out in the Fair Dealing Document.
- **Proficiency**: Both the firm and the representative are responsible for ensuring the representative is competent to perform the services contracted for, including being able to advise on the subject matter of the transaction.
- **Client suggestions**: A representative may accept a client's trading suggestion, provided that it is consistent with the Fair Dealing Document and the representative is prepared to accept some responsibility for it. There is flexibility within the model for investors and representatives to accept different levels of responsibility for asset allocation decisions, as long as they document their choice.

A closely related topic is how regulators and judges would determine whether the choice of investments is appropriate.

Choice of investments. In the event of a later dispute or complaint, how would a decision-maker determine whether a particular transaction was appropriate for a client? Some of the

27 "Informing consumers: product disclosure at the point of sale" (Feb. 2003), http://www.fsa.gov.uk/pubs/cp/cp170.pdf.

current regulations are designed to answer this question on a trade-by-trade basis, but we believe the answer should always be based on a more complete set of considerations.

> ***The appropriateness of individual transactions will be evaluated in the context of the investor's overall portfolio.***

The key point of reference will be the objectives agreed upon in the Fair Dealing Document for the particular account. For example, if an investor has agreed to allocate a certain portion of the portfolio to high-risk or speculative investments, then the purchase of a high-risk or speculative stock may be entirely appropriate. That same stock, however, could be deemed unsuitable for someone seeking greater income and stability. And a portfolio that is very highly weighted in any single security or sector is likely to be inconsistent with most Fair Dealing Documents – though it is conceivable the parties could agree otherwise.

The compensation a representative earns from a trade may also be relevant in determining whether a recommendation was appropriate. Specifically, we propose to introduce the following requirement.

> ***In an Advisory or Managed-For-You relationship, compensation must not be the primary motivator for any advice. Recommendations or discretionary decisions must be based on the representative's expert judgment and the objectives agreed upon in the Fair Dealing Document.***

Naturally, representatives are entitled to be paid for their services. But the principles of fair dealing require that compensation should not drive their recommendations. The investor's interests and objectives should be the only factor considered.

If a transaction has resulted in unusually high compensation, a representative may be called upon to rebut a claim made by a client – or by regulators – that this influenced the recommendation. The rebuttal could be a challenge where recommendations have led to situations like the following:

- Buying and selling investments at a rate or at a time that can't be justified by the investor's stated objectives (churning).
- Switching to an equivalent mutual fund from another manager when the redemption schedule on an existing fund has ended.
- Buying a security that generates significantly higher representative compensation than equivalent alternatives. (See, for example, "Compensation Case Study 2" in Appendix F.)

Other circumstances might also be relevant in determining whether compensation influenced a recommendation. For example, could the investor's objectives have been better met through non-fee generating decisions, like paying off debt? Was a firm offering its representatives incentives designed to achieve sales targets for a particular security? This latter question might also be asked when representatives are paid solicitation fees for clients who accept a take-over bid or vote their shares in a specified manner. The general prohibition against compensation influencing advice is applicable in such situations.

Representatives would not be barred from making recommendations that happen to generate high fees. But if challenged, they must consider how they could show that in making that recommendation, they met the requirement that their advice not be influenced by its benefit to themselves rather than to the client. We recognise, of course, that the client and representative have a commercial relationship. A presumption of undue influence would require something more than the mere fact that the representative has received compensation for services.

This proposal is less stringent than schemes proposed or implemented by other regulators, for example the Financial Services Authority's controversial requirement applicable to U.K. advisers who recommended the pension products of a related third party issuer. These advisers were required to be able to demonstrate that the security they recommended was a better investment than any possible alternative.

The Fair Dealing Model would not prohibit compensation biases in a Self-Managed relationship. Because investors are not relying on their advice, and are responsible for assessing the information they get, representatives would be free to attempt to sell any security, as long as they disclose all compensation and any potential bias.

Best execution. There are a number of factors that contribute to achieving best execution for the investor, including the timing of execution, the venue of execution, the liquidity of the security, client needs, alternative versions of the same product, and direct and indirect costs.

> ***Where a financial services provider executes a trade on a client's behalf, fair dealing requires best execution, regardless of whether the provider trades as agent or principal.***

The Fair Dealing Model does not propose to prescribe specific standards for best execution. What is "best" will vary with the client's situation. For many investors, best price may be the test, but any of the factors noted above maybe more relevant to others. For example, an investor tracking an index would be concerned with the time of day the order was placed, and an investor trading a large block might be less concerned with current market price than with the possible fragmentation of his order. We expect the representative in an Advisory or Managed-For-You relationship to take any special requirements into account to ensure best execution for that particular client.

In a Self-Managed relationship, clients must communicate any special execution requirements to the service provider with their order. The Self-Managed relationship is impersonal, with the client making all the choices. Financial services providers offering Self-Managed relationships will have to consider how far they want or need to go in accommodating special requirements on a trade by trade basis in order to achieve client-specific best execution – perhaps by offering a limited menu of execution choices up front.

There are also many hidden costs that affect managed investment funds or a Managed-For-You relationship. An example is the "soft dollar" arrangements included in trading costs in return for research and other services and benefits. The opacity of these arrangements reduces or eliminates the managers' incentive to achieve best execution and, in fact, may be an incentive to increase costs.[28] These costs do not show up in management expenses and are charged directly to the fund, reducing the return to investors.

Compliance. In our view, most firms already have adequate compliance structures in place to implement the Fair Dealing Model. Some firms may need to establish a few new practices, such as the following:

- maintain records of client conversations
- ensure information systems record the data necessary to generate the transaction summaries, account statements and any other materials required by the model
- inform the investor in advance if a representative is not licensed to sell a particular security directly, resulting in extra transaction costs (i.e. jitney costs)

In general, and wherever practical, we would expect firms to take reasonable steps to make it easier for their representatives to comply with the model.

Information provided to investors

Under the Fair Dealing Model, financial services providers in Self-Managed and Advisory relationships would be required to provide several forms of transaction-related information to investors, as shown in the following table.[29] Each is discussed below.

Information	When required?
Information Sheets	Mandatory one time only (prior to the first transaction) for Advisory and Self-Managed relationships
Transaction Summaries	Mandatory for every Advisory transaction; mandatory for Self-Managed unless on-line, where firm and client can agree to waive
Confirmations	Mandatory for every Advisory and Self-Managed transaction
Research reports	Optional

Information Sheets. We described Information Sheets in Stage 1, and provided samples in Appendix B. We mention them again here as a reminder that investors must have an opportunity to review them prior to completing their first transaction in a particular type of security. There are two valid viewpoints on the best time to provide the Information Sheets. Investors would

28 FSA paper, "Bundled Brokerage and Soft Commission", http://www.fsa.gov.uk/pubs/cp/cpl/76.pdf.

29 In a Managed-For-You relationship, the investor is not participating in the transaction decisions, and therefore would not benefit from any documentation designed to assist in the decision-making process on specific transactions. Managed-For-You representatives need to make their clients aware of the nature of the investments being made with their funds, particularly the relative risk level, and assist them in understanding the investment approach being taken. We do not propose to prescribe detailed information guidelines for this relationship as we have for the others.

have more time to digest the content if it is provided at the account opening stage. On the other hand, people are generally more likely to read and absorb material when they need to know it – that is, when they are considering a transaction.

Transaction Summaries. The details of any proposed purchase or sale of securities should be clear to investors in Advisory relationships so that they can make an informed decision before proceeding. And Self-Managed investors need to be able to catch errors. Disputes or complaints are often traced back to specific transactions, with investors claiming they didn't really understand what they were buying. To help increase transparency and reduce the likelihood of disputes, we are proposing to introduce a requirement that is absent in the traditional regulatory regime.[30]

> ***Prior to the execution of any transaction, financial services providers would be required to provide a written or oral summary of the essential features of the transaction to all Advisory investors and certain Self-Managed investors.***

There would be flexibility in the form a Transaction Summary might take. For example, an investor placing an online order might see the information as a "pop-up" message on a computer screen, while investors phoning in trading instructions would likely have the key details read to them. In a conversation, the representative in an Advisory relationship should make a reasonable effort to ensure the investor understands the information. In any case, we would not expect this proposal to result in lengthy conversations or detailed documents.

This proposal would ensure that clients in an Advisory relationship are provided with key issuer information relevant to the advice given and the decision made. It recognizes the key role of firms and their representatives in Advisory relationships in organizing and filtering information to support client decisions.

We would likely relax this requirement for some Self-Managed accounts. Investors who trade impersonally on-line should be able to elect whether to receive a Transaction Summary. If clients feel they could not benefit from the information, requiring firms to provide one would only create an unnecessary administrative burden. For all other Self-Managed investors, such as those who execute trades through a particular representative, we believe it would be prudent to require that Transaction Summaries be provided.

Transaction Summaries could include the following content:

- **Identification of the security**: This includes basic information like issuer name, fund name, bond series, etc.

---

30 Our proposal for enhancing the representative's responsibilities to provide better information to investors prior to transactions, and to take steps to assist them in understanding the information, is consistent with the recent decision of the Ontario Court of Appeal in *Transpacific Sales Ltd. (Trustee) v. Sprott Securities Ltd.*, [2003] O.J. No. 3900, Docket No. C36029 (O.C.A.), which articulates the representative's duty of care at the point of sale.

- **Price and quantity**: The summary should show the price per unit of the security, the number of units bought or sold (if known), and the dollar value of the trade. If the exact price is not known prior to the trade it should be estimated.
- **Applicable fees**: All compensation, service charges and other fees associated with a transaction should be disclosed in advance. (We discuss the implications for different types of securities below, in the section titled "Transparency of compensation received".)
- **Information relating to the risk level**: The risk level associated with the particular security being considered should be disclosed. (Please see the more detailed discussion below, under the heading "Communicating the risk levels of individual securities".)
- **Reason for the recommendation**: In Advisory relationships, the representative should provide a brief explanation of why the transaction was advised. The explanation might include, for example, the transaction's fit with the objectives outlined in the Fair Dealing Document or the overall portfolio. Alternatively, if the transaction was not advised – that is, if it was the investor's idea – the Transaction Summary could indicate this. However, in an Advisory relationship, the representative is understood to be approving each transaction as fitting within the parameters of the governing Fair Dealing Document. The representative must accept this responsibility for all trades, regardless of who initiated them. The reason for the recommendation is not required in a Self-Managed relationship.

In Appendix C, we've provided templates for Transaction Summaries for equity, bond and mutual fund trades.

Effectively, the Transaction Summary would serve as a pre-trade confirmation: the investor's final opportunity to decide whether or not to approve the trade, or to request further information. Having approved each transaction with full information about its key features, investors will find it difficult to claim ignorance of those features in any future disputes. We expect that financial services providers will take care to document each Transaction Summary, or to ensure that one is systematically delivered before every trade. If the information called for in the Transaction Summary template is the same as the information in the confirmation (described below), the latter can serve as the documentation of an oral transaction summary.

It is interesting to compare our proposals with legislation enacted in 2002 in Australia. Advisers there are also required to provide investors with transaction information before a purchase is confirmed, but the content requirements are more onerous. The disclosure must include any interests, associations or relationships that might reasonably be expected to influence the financial services provider in providing the advice. And representatives who recommend replacing one investment with another must disclose the costs of the recommended action, the potential benefits that may be lost, and any other significant consequences of the switch. In our view, the Fair Dealing Model tries to avoid requiring such strict disclosure with every transaction, by taking the time up front (i.e. at the account opening stage) to set the basic parameters of the relationship. In an Advisory relationship, good faith is a given, and conflict management does not depend on the client assessing a complex array of potential conflicts.

Comment requested

Should our Transaction Summary proposal be made mandatory, or should it remain a voluntary best practice?

Are there circumstances where investors should be able to opt out of receiving a Transaction Summary?

Should some of the information in the Transaction Summary be optional? For example, are there circumstances where the risk level and the reason for the recommendation should not need to be disclosed?

Confirmations. Under current requirements, upon settlement of a transaction, investors receive a written confirmation of its final terms. We are not proposing changes to existing requirements relating to the delivery or timing of confirmations, but to improve transparency, we are making a content-related proposal that would apply only to mutual fund purchases.

> ***Confirmations for mutual fund purchases would show the specific amount of compensation (fees and commissions) the investor has paid or is potentially committed to pay, directly or indirectly, to the dealer and the representative.***

If a fund carries a back-end load, the confirmation would state the percentage payable if sold immediately, whether the percentage is based on the purchase price or the proceeds, and the number of years for the back-end load to reach zero. It would also show the commission payable to the selling agent at the time of purchase. If the fund had a front-end load, the confirmation would show the amount of the load paid for each fund acquired, and the aggregate front-end load if the investor bought more than one fund. If any of this information were given to the investor in writing in advance, it would not need to be included in the confirmation.

For individuals who have both an Advisory and a Self-Managed account at the same firm, all confirmations would show which account the trade relates to.

Appendix C includes a sample confirmation template for equity, bond and mutual fund transactions.

Research reports. The Canadian regulatory approach to analyst reports has been that they are not required, but if offered, they must meet certain standards. We do not propose to change this. We treat analysts' reports as one aspect of the broader retail investment relationship. Our conflict management principle calls for a consistent approach to all structural conflicts arising from a full service firm's other business activities and competing client loyalties. The Fair Dealing Model requirement that a firm's retail business must be kept at arm's length from other business areas means that any research reports provided by a firm to representatives and their clients must not be biased in favour of the firm's other interests.[31]

---

31 Reportedly, CIBC recently strengthened its Chinese wall by prohibiting investment bankers from influencing research reports. See "CIBC bans e-mail between its investment bankers, analysts", Globe and Mail, August 11, 2003.

We discussed the conflicts inherent in the structure of full service dealers in Part III. A firm's "other interests", in this context, might include its actual or desired underwriting relationships, bank loans, or its own holdings in the securities that are the subject of the research. We would consider research to be biased if its conclusions are based more on these other interests than on the investment prospects of the security.

We believe potential conflicts are best managed by ensuring that only research written primarily to serve the interests of the investor can be used in giving advice.

The Investment Dealers Association's "Policy 11 – Analyst Standards" addresses potential conflicts from the perspective of analysts and firms. The Fair Dealing Model would add a novel approach, in that it places an additional onus on the individual representative to filter any biased information supplied by the firm. This adds a second line of defence against conflicts. The firm remains under an obligation not to supply self-serving information, but this is supplemented by the representative's duty to the advised client to assess it critically.

Q: How would this requirement affect the use of analyst reports typically prepared by full service dealers?

A: If research is unbiased, then the firm has nothing to worry about. Rather than boilerplate disclosure about a variety of potential conflicts a firm may have, which is of little assistance to investors in assessing the reliability of a particular piece of analysis, the firm has to assure itself that the information and assessments being provided to the retail representatives and clients are objectively prepared. It is our hope that this requirement would give firms an extra incentive to ensure their research recommendations reflect the investment prospects of a security, and nothing else.

Comment requested

How should firms resolve the conflict if they have both retail and institutional clients, but develop some information for higher value accounts only, or provide it to them at an earlier time? Should the firm certify that all information known to the firm has been taken into account? Or should the prohibition on favouring the non-retail business at the expense of the retail business work both ways?

Mutual fund disclosure obligations. Implementing the Fair Dealing Model's conduct standards would create an opportunity to simplify and improve mutual fund point of sale disclosure and allow us to allocate responsibilities for disseminating information more efficiently. As we described above in the sections titled "Obligations governing transaction advice and execution" and "Increased responsibilities for representatives", mutual fund managers would remain responsible for the content they prepare, but they would no longer need to deliver a prospectus at point of sale.

The obligation to distribute relevant information to the investor at the time of the transaction would rest with the financial services provider and its representative. But they would depend on the fund manager to gather and present facts about each mutual fund for this purpose, including more detail than is currently provided about the fund as a portfolio management vehicle. The obligations of fund managers would include:

- Preparing a "foundation document" and maintaining a continuous disclosure record, either on a fund management company's website or through a link to a list of the mutual fund's documents on SEDAR. Hard copies of this material could be obtained from the fund management company on request.
- Making readily accessible, perhaps through a link on its website, a "summary sheet" for each mutual fund. This would include the content representatives will need to satisfy their own disclosure obligations to investors under the Fair Dealing Model (see Appendix C). Firms and representatives could provide this summary sheet to their clients in the sample format, or as part of their own Transaction Summary.

The fund management company would be responsible for this information to the investor and firm making use of it. Firms that incorporate the fund manager's information into their own materials, or representatives who interpret it, would be responsible to the investor for any additions or modifications.

Firms and representatives would also be responsible for generating certain information – particularly facts about sales compensation and total cost to the investor. In the case of a periodic investment plan, the financial services provider's obligation to provide transaction information to the investor arises only when an investment decision is made, not each time the investor makes a purchase.

Integration with Joint Forum proposals. In its Consultation Paper,[32] the Joint Forum of Financial Market Regulators pointed out that a significant "disconnect" exists between the theory of protecting mutual fund investors through disclosure at the point of sale and the way current disclosure requirements work in practice. The paper concluded that the delivery of a prospectus at point of sale did not generally serve its intended purpose of informing investors, while imposing large costs for preparation, production and delivery of the disclosure.

The Fair Dealing Model's point of sale disclosure proposals for mutual funds are largely consistent with the proposals set out in the Consultation Paper. A few minor differences exist between the two proposals:

- The Consultation Paper contemplates that the dealer or representative would be required to provide to the investor all of the information the fund management company includes in the summary sheet. However, the Fair Dealing Model contemplates that the dealer or representative might have more abbreviated disclosure requirements, corresponding more closely to our requirements for other securities. The more abbreviated requirements would facilitate telephone transactions.
- The Fair Dealing Model would not require disclosure of a fund's past performance, which is of debatable significance for investment decisions. Rather, the Fair Dealing Model would require that personal portfolio performance, including mutual fund holdings, be reported to the client.

32 *Supra* note 26.

- Under the Fair Dealing Model, the Information Sheet for mutual funds, like the other Information Sheets, may be used as set out in the samples in Appendix B or modified by a financial services provider. Irrelevant content could be eliminated. For example, a dealer that is paid only by asset-based fees could simplify its mutual fund Information Sheet significantly by deleting much of the content concerning fees. For an equity Information Sheet, among the many ways of measuring risk, only those actually used by a financial services provider would need to be covered. The Consultation Paper, on the other hand, proposes to deliver a consumers' guide with prescribed content and no variation permitted.

Transparency of compensation received

Investors should be aware of the nature and amount of the compensation their financial services providers receive for completing transactions on their behalf. We believe an understanding of this information is essential to achieving transparency, and to managing potential conflicts – two of the three core principles of fair dealing we discussed in Part III of this paper.

We have found that there is much room to improve compensation transparency, and that existing rules and practices are inconsistent. We propose a requirement that would be broadly applicable.

> ***Financial services providers must disclose the total incremental cost of each transaction to clients, including all amounts of compensation received.***

This disclosure would be made in advance, in the Transaction Summary prepared before each trade. Where it is possible to show the precise dollar amount in advance – for example, where a firm charges a flat rate for trading a certain number of shares in a certain price range – this level of detail would be provided. Where the precise amount cannot be determined until after the transaction is executed, then the Transaction Summary would still disclose details of how the fees are calculated, or an estimated dollar amount.

We are not proposing to change or regulate directly the way financial services providers are compensated. In most cases, we consider increased transparency to be a sufficient means of managing any conflicts. However, transparency has limitations as a means to control the conflicts of interest and compensation biases created by complex third-party sales compensation structures embedded in pooled asset management vehicles. This is a concern for us and for other regulators as well.[33]

Since the nature of compensation varies greatly between shares, bonds, mutual funds, and wrap accounts, we have different transparency concerns – summarized in the table below. We deal separately with the implications for each type of investment.

---

33 Third-party compensation by fund management companies is the one exception where we are considering regulating the manner of compensation. At the end of Part III, we discuss three possible alternatives for managing the conflicts inherent in these payments, including the option of prohibiting the practice.

Type of security	Transparency challenges
Shares	Compensation information not available prior to transaction
Bonds	Buy-sell price spreads not identified as compensation to the firm Market prices of bonds not yet available to investor
Mutual funds	Complexity of third party compensation structures
Wrap accounts	Embedded fees and compensation structures in underlying investments Effects of transferring account to another firm

Shares. Compensation tends to be more transparent for shares trading in the secondary market than for other types of investments. Discount brokers in particular are quite forthcoming with their fees, since price is a major competitive factor in that market. Among full service brokers who charge commissions, the compensation amount is stated on confirmations after a transaction is executed, but its availability prior to the transaction can vary.[34] We would require them to include in the Transaction Summary as much fee information as possible.

In the primary market for shares – e.g. initial public offerings – it is common for investment banking firms to offer their representatives higher compensation as an incentive to sell the offering. To achieve full transparency, the representative would need to disclose both the amount of compensation received, and the fact that it exceeds the fees they would typically receive on a sale of shares.

Similarly, the requirement to disclose compensation would apply to representatives in situations where they receive solicitation fees for clients who accept a take-over bid or vote their shares in a specified manner. It may not otherwise occur to investors (even those who read the offering circular) that the representative receives any payment.

Bonds. Transparency in bond trading is more problematic – for both individual trades and the market overall. Investors may be misled by the fact that typically no commissions are charged on trades. Some financial services providers explicitly state that fixed income securities transactions are commission-free, without mentioning that firms are actually compensated by the spread between the prices at which they buy and sell bonds. Investors can be unaware of the size, or even the existence, of the spread. A recent study of Canada's fixed income markets found the following:

34 One survey of full service brokers found that many will not provide commission schedules, even to existing clients. "The Fee Slip Is in the Mail", National Post, Nov. 7, 2000.

> A strong consensus exists that reforms are needed in the retail market. The primary issue is poor transparency, which is increasingly an issue in light of advances in transparency in wholesale markets. Poor transparency can lead to other problems such as unreasonable prices or mark-ups, lack of understanding of the debt markets, and clients' inability to safeguard their own interests.[35]

This situation raises two issues for the Fair Dealing Model. One is achieving price transparency at all. On this issue, although the Fair Dealing Model endorses the principle of transparency generally, we acknowledge that the operation of financial markets is beyond the scope of the model. However, we are aware that regulators and industry are currently paying considerable attention to achieving price transparency, and therefore fairer pricing, in the Canadian bond markets.[36] Increased use of Alternative Trading Systems for bonds is also expected to support this outcome.

The other issue is how we would expect conflicts of interest to be managed where prices may be opaque yet service providers frequently trade as principal.

> ***On all bond transactions, financial services providers acting as principal would be required to provide quotes or information respectively at the point of sale on both a buy price and a sell price.***

Where the financial services provider acts as principal, it would have to provide either price quotes or information at the point of sale. The prices quoted for over-the-counter debt should be those at which the firm would be *willing* to trade. The quote should not be influenced by the fact that a firm will usually know whether a particular investor is interested in buying or selling the bonds. In other words, an investor looking to buy and an investor looking to sell should each be quoted the same buy price and sell price. If price information were available from an Alternative Trading System, the price transparency achieved by the marketplace, combined with the Fair Dealing Model's best execution requirement, would neutralize the conflict of interest created by the service provider's principal position on the trade.

If the financial services provider is trading the bond as an agent, the obligation to provide price information on the trade and the best execution requirement would apply.

Comment requested

Is this approach to bond price transparency feasible? Is there an alternative method of achieving transparency of compensation on bond transactions?

35 Deloitte & Touche, "Market Survey on Regulation of Fixed Income Markets," July 2002. Prepared for the Canadian Securities Administrators and the Investment Dealers Association of Canada

36 National Instrument 21-101 introduces requirements for government and corporate bond transparency under which Alternative Trading Systems, inter-dealer bond brokers and other dealers must disclose post-trade information on corporate bonds.

Comment requested

Should the portion of the spread representing the representative's commission be split out from the wholesale cost in order to provide transparency on adviser compensation relative to the cost of execution at the firm?

Mutual funds. Mutual funds also present significant compensation transparency challenges for those who sell them. Some of the problems stem from the traditional reliance on prospectuses to convey the information. As discussed above, we would eliminate the prospectus requirement and substitute a formal recognition of the role of the dealer and the individual representative in collecting and assessing investment decision-making information in an Advisory relationship. We believe investors would have a better chance of understanding mutual fund fees if the information were presented in a simpler format, related to their own circumstances and portfolio, directly from the person they are relying on as they are making their investment decision.

A more difficult challenge in achieving transparency results from the complexity of mutual fund fees themselves. A dealer's compensation may be derived in part from the investor directly, and partly from a third party – the fund management company. Third party compensation can include both one-time and on-going payments, with an increasing number of payment schedule options being made available by the fund management companies.[37] This complexity makes it harder to calculate the fees applicable to any single transaction, while at the same time making it even more important that investors understand how much they are paying.

We are proposing to enhance the transparency of mutual fund fees.[38] Our general requirement for compensation transparency applies, but for greater clarity, we restate it in the context of mutual funds.

> ***A firm executing trades in mutual funds must provide investors with specific information about the nature and amount of compensation the firm would receive from a transaction, including any benefits received from a third party.***

We recognize that financial services providers do not currently calculate fees in this way. Our view is that this disclosure may be necessary to manage the potential conflict that occurs when a third party compensates a financial services provider for its client choosing to invest in the third party's pooled investment vehicles. If mutual fund compensation structures were simplified, the information would become far more straightforward both to calculate and to communicate. We

---

37 In Appendix F we have provided several case studies illustrating the complexity of mutual fund compensation schemes, and their potential to lead to biased recommendations. In reading the case studies, it becomes apparent that the average investor would find it difficult to piece together and interpret the available information in a way that is meaningful to his own situation.

38 As we outlined at the end of Part III, we have proposed three approaches for addressing the conflicts that result from third-party compensation. Enhanced transparency is one of those approaches, and it could also be combined with one of the others.

illustrate this with alternative versions of the Information Sheets and Transaction Summaries in Appendices B and C.

We would give similar treatment to other managed funds with a structure similar to mutual funds, such as hedge funds. These raise the same conflict of interest and compensation transparency issues as mutual funds, and would be amenable to the same solutions.

Wrap accounts. Wrap accounts typically charge an up-front, asset-based fee, which in itself is easy to communicate to investors. The transparency issue results from the other bundled fees and embedded compensation typically received by the financial services provider when the account invests in securities like mutual funds.[39] As we described above in the discussion of mutual fund compensation, we don't consider disclosure in a lengthy prospectus to be an adequate means of achieving transparency. Our concern is actually magnified here, because even investors who read their wrap account contract may mistakenly believe that the up-front fee is the only compensation they are paying. Financial services providers offering wrap accounts must take care to ensure that the total amount of all fees is communicated clearly.

One additional point of sale requirement would arise under the Fair Dealing Model, due to the possibility that the investor may eventually close the account.

> ***At the point an investor first commits to a wrap account, the financial services provider must disclose if a transfer of the account to another firm will require the sale of some or all of the investments in the account and the payment of tax on any capital gains.***

This disclosure could be provided orally if a representative provides an investor with information about a wrap account in a meeting or by telephone. It must also be included in a written recommendation provided to the investor.

Communicating the risk levels of individual securities

We discussed the importance of risk transparency in Part III. Investor awareness of the riskiness of a security is never more essential than at the transaction stage, where the investment decision is actually made.

Earlier we proposed that communication of risk levels should be a required element of the Transaction Summary that must be provided to both Self-Managed and Advisory investors.[40] In

---

39 Compensation Case Study 1 in Appendix F illustrates the difficulty of determining the actual costs to the investor when services are bundled and provided as part of a complex structure. Most investors lack the time and skill required to perform this calculation – especially given that the complete information is usually not even available to the public. While technically not a wrap account, the transparency issues raised by Case Study 1 structure are comparable. Some wrap accounts include both proprietary and third party investment funds, whereby the firm would receive both an account-based wrap fee and part or all of the embedded fund management fees.

40 Recall that Managed-For-You representatives would not provide transaction documentation, since their clients are not involved in trading decisions.

the case of Self-Managed accounts, the financial services provider's duty is limited to providing the information, and the client is responsible for assessing its significance. But we expect that a representative who has entered an Advisory relationship with a client should assume greater responsibility for communicating risk information at the point of sale.

> ***Before any transaction is completed, the financial services provider in an Advisory relationship should provide the investor with meaningful information about the riskiness of the security, and how it would affect the investor's portfolio.***

We expect the nature of the communications to be tailored to the audience. "Meaningful information" about risk for one investor might include sophisticated numerical measures, while others might be more comfortable with a plain English description of the possible outcomes of the investment.

We do not intend to prescribe a single method for determining risk levels, but the method used must be one that is generally accepted by experts. Three accepted alternatives for assessing the risk level of a particular security are: making a subjective analysis of a security issuer's prospects; applying a rule of thumb test based on a few features; and applying a mathematical formula (such as a standard deviation measure) to historical data.[41]

Each method has its strengths and weaknesses. For example, a formula has the advantage of being applicable quickly and cheaply to large numbers of securities, including those which a financial services provider has not analyzed by other methods. On the other hand, formulas rely solely on historical data, and they take no account of qualitative information or subjective assessments about the prospects for the economy or a particular industry. Formulas that rely on historical data have limited usefulness where there is a fundamental change in the issuer's business compared with the period for which data was collected. Information about alternative quantitative risk measures and risk presentation methods can be found in Appendix E.

In an Advisory relationship, the riskiness of individual securities should be communicated in the context of the investor's overall portfolio and the Fair Dealing Document.[42] A thorough discussion is especially important when the security is not an obvious fit with the agreed upon investment objectives. The duty to communicate risk information applies even where the investor initiates a trade. Communication alone, however, is not sufficient to discharge the representative's, and the firm's, ultimate responsibility for ensuring that each trade fits the investor's risk profile.

---

41 These methods are either summarized or presented in detail in the IDA's "Equity Margin Discussion Paper," Draft #13, March 10, 2003, referred to at www.ida.ca.

42 Specifically, the representative should be aware of the content of the "My Investment Goals" and "Initial Approach to Investing for the Account" sections of the agreement. A sample Fair Dealing Document for an Advisory relationship is presented in Appendix A.

Comment requested

Is it important, or even possible, to achieve risk measurement consistency across the industry?

What different methods do firms currently use to assess risk levels?

With the likelihood of legitimate differences of opinion among representatives, how could consistency in risk measurement be achieved on a firm-wide basis?

Stage 3: Relationship Maintenance – Ongoing Responsibilities

Relationship maintenance, though classified in this Concept Paper as the third phase in the relationship, is in reality an ongoing series of events. While the first two phases describe specific events – account opening or transaction execution – Stage 3 is effectively a "catch-all" category designed to highlight how the Fair Dealing Model would affect other important activities.

Relationship maintenance includes periodic written reports to clients, as well as more intangible items like the following: a representative's responsibility to monitor the account, the investor's responsibility to inform the representative of significant changes in circumstances, frequency of meetings or phone calls, client alerts (if any), financial planning or estate planning services (if any), the complaint process, and the duty to update the Fair Dealing Document.

Some of these activities are customer service matters best left to the parties and the market to resolve.[43] Others, however, are fundamental to achieving the principles we describe in Part III, yet they are not currently subject to an acceptable minimum standard. We are proposing to establish specific standards in three areas: the content of account statements, the financial services provider's obligations to monitor accounts, and the shared responsibility for updating the Fair Dealing Document.

Content of account statements

Effective reporting is an important aspect of transparency. All financial services providers are required to offer some manner of account statement to their clients, though the form and content varies significantly.[44]

We are not suggesting changes to the timing or manner of providing periodic reports to investors. We are, however, proposing to set new standards for the information contained in account statements which go beyond what most firms currently adhere to.

43 The model would allow the parties to agree to certain parameters of their relationship, requiring only that they record the outcome in the Fair Dealing Document.

44 Account statements are one form of reporting – the only one with which the Fair Dealing Model is concerned. The parties may also agree to other forms of reporting, such as special alerts and updates or regular meetings.

Reports to clients must include the following components:

- ***personalized performance information***
- ***the aggregated costs of compensation incurred by the investor***
- ***an analysis of the portfolio's risk level***

Over the next seven pages we discuss each of these requirements in detail. Appendix E includes a model account statement, labelled George's Statement, which we have created to illustrate the concepts discussed throughout this section.

Personalized performance information. Account statements do not typically differentiate between changes in the account balance attributable to investment performance, and changes resulting from the investor's cash contributions or withdrawals. Most statements do show a beginning and ending balance, and perhaps the period's cash inflows and outflows, but this does not tell the average investor how well their investments performed.

Consider, for example, the case of two investors who each open the year with $1,000 in their accounts and end the year with $1,500. During the year, one contributed an additional $100 per month, while the other made no new contributions. The performance of their portfolios differed greatly. One investor can quite easily calculate her return, but the other cannot, except to know that it is negative. The typical account statement would leave one of the most important questions unanswered.

Statements must provide personalized performance information – defined as the percentage change in value, over a specified time period, of all the funds the investor has contributed to her account.

In our simplified example, the investor who made monthly contributions would learn that the return on the funds she invested was negative 30% (depending of course on how the price of the assets fluctuates each month) – surely a more relevant figure than the 50% increase in her account balance. We understand that this level of detail is routinely provided to institutional investors, but that the practice remains rare for retail investors.

Other details of the requirements we are proposing in this area include the following:

- **Calculation method**: There is more than one acceptable way to calculate personalized returns.[45] We are not committed to any particular formula, or even necessarily to the idea of prescribing a single formula.
- **Securities included**: A personalized return should be calculated for the portfolio as a whole, as well as for each individual security held in the account.

45 For example, in National Instrument 81-102, section 15.10, the Canadian Securities Administrators prescribe a specific formula for use by mutual funds. Fund companies face a similar issue in calculating performance results that take account of frequent inflows and outflows from a fund.

- **Timeframe**: Statements should report personalized results achieved in the current quarter, as well as those achieved over a reasonably long period. We believe five-year annualized returns are appropriate, for accounts that have been open that long.
- **Frequency**: Personalized performance information would be mandatory in each account statement, or on a daily or real time basis on the Internet, as agreed to in the Fair Dealing Document.
- **Target returns**: Where the financial services provider and the investor have agreed upon a targeted annual return, the statements should compare the target and the actual return.

Access to personalized returns would offer investors a number of important benefits. It would provide them with an earlier warning about potential problems with their portfolio and allow them to address the problems at an earlier stage. By allowing them to compare their actual returns to their targeted returns, the information would help investors assess the value of the services they've received, and possibly lead to a decision to adjust the target. And it would give investors who may currently rely on other data sources a more realistic impression of how their own investments are faring.[46]

We recognize that there are practical challenges for many financial services providers to overcome before they can offer this kind of individualized reporting. Many firms do not have record-keeping or data analysis systems in place to support personal performance calculations. The calculation is inherently complex, especially for accounts with frequent cash inflows and outflows. However, software is available to do this – mutual funds face this exact issue in calculating their returns – and could become more common if the practise of reporting personalized returns becomes widespread.

Another obstacle is that, because they have not been providing this information, some firms may not have stored the necessary historical purchase cost data in the appropriate database. But the data is collected for the purpose of order confirmations. We also note that firms already need to maintain this information to determine whether RRSPs remain within foreign content limits. A possible solution would be to allow financial services providers the option of calculating personalized returns on a going forward basis only.

46 Investors are frequently exposed to mutual fund performance data, through the media or through mutual fund advertising. Some newspapers produce regular monthly sections containing detailed information on all Canadian mutual funds, together with tables and articles highlighting the performance of particular funds. At least one newspaper even prints daily tables of the top movers among mutual funds. Without personalized data, this information can be misleading. For example, studies have shown that mutual fund investors generally under-perform their mutual funds significantly, after accounting for costs.

Comment requested

Should we prescribe the formula for calculating personalized returns? Should we approve a number of acceptable alternatives?

Should performance information be provided to investors for each individual security, or only for the overall portfolio?

Should account statements be required to show returns on a dollar or percentage basis?

Should returns be calculated on the basis of the past year, or since the date of purchase? How difficult will it be to obtain book value information for each security?

Should we prescribe how frequently personalized performance information should be provided to investors? (e.g. Monthly? Quarterly? Annually?)

Benchmarks. A related topic is the use of external benchmarks such as stock market indices in account statements as a barometer of portfolio performance. Investors are better informed if they know how their own investments have performed in relation to the broader market. There are also a number of drawbacks to the use of benchmarking, including the potential for setting unrealistic expectations. Appendix E contains a more complete discussion of the use of benchmarks.

Some financial services providers include benchmarks in their statements, but there is no requirement to do so, and no consistent standard for ensuring appropriate measures are chosen.

> ***Reporting external benchmarks would not be mandatory, but if an account statement includes them, the regulations would set minimum standards to require that the benchmarks chosen are appropriate to the investor's portfolio.***

Securities included in the benchmark should be comparable to the investor's portfolio. For example, the S&P/TSX Composite Index might be an appropriate benchmark for some portfolios, but it would be inadequate for investors with heavy weightings in debt or international equities.

Another important consideration is the time period covered by a benchmark. Generally, the longer the time period, the more useful the benchmark will be as a measure of performance.

Comment requested

Should we require account statements to include external benchmarks?

What kind of standards should we set for the use of external benchmarks?

Should we consider requiring statements to provide both gross and net returns?

Aggregating costs of compensation over a period. In our discussion of the transaction stage, we described the requirement to fully disclose compensation received at the time of each transaction. We are proposing to apply a similar requirement to account statements for all three relationship types.

> ***Annual account statements would be required to disclose the aggregate compensation paid to the financial services provider and other costs incurred on the account over the past year.***

We believe an annual summary of the fees they've paid would be very useful to investors. It would enhance transparency by increasing investors' awareness of how much they are paying for the financial services provider's services. While communicating more clearly at the point of sale also should improve investors' understanding about fees, it is not a substitute for seeing the actual dollar amount paid during the year. This disclosure would also enable investors to make a more informed choice among available fee options. For example, an investor could more readily ascertain whether or not a percentage fee based on the size of the account would be more desirable.

The aggregate compensation calculation would include all the dollar amounts required to be disclosed at the transaction stage. Summing these up at year-end should be a fairly straightforward task. But the aggregate calculation would also include types of compensation that cannot easily be calculated at the time of the trade – particularly fees related to investment funds, such as trailer fees and management fees. Current compensation systems raise a number of complications in calculating aggregate amounts.

For example, computation problems arise where the financial services provider would have to combine amounts paid directly by the investor and amounts paid indirectly through the fund management company. Some amounts such as trailer fees may vary on a daily basis. Attribution problems arise in the case of back-end loads, where the amount paid to the client's financial services provider during the year does not correspond to the amount paid by the investor during the same year.

Until now, providing aggregate cost data to clients has been hindered by problems financial services providers experience in coming up with accurate numbers compiled on a consistent basis. Because it is not the current industry practice to disclose aggregate compensation, this requirement may lead to some uncertainty or complexity involved in standardizing the calculation. Below we propose some solutions and reasonable approximations.

Trailer fees: The main difficulty in disclosing the trailer fees paid by a specific investor is a result of the way they are calculated. Many fund managers do not calculate trailer fees on a client-by-client basis, since they currently base the payments on the aggregate amount held by all the clients of a dealer or a representative. However, we understand that the technology exists or could be put in place to track this information.

Market participants in the U.S. did some work on this issue after the General Accounting Office (GAO) recommended that quarterly reports sent to investors should show the dollar amounts paid for mutual fund management fees. The Investment Company Institute, a trade association, commissioned PricewaterhouseCoopers to survey mutual fund companies about the cost of producing this information. The study obtained information from 39 mutual fund companies and firms that provide services to mutual funds. Based on the study's results, the GAO estimated that production of the necessary data would cost approximately US$1.00 per account initially and US$0.35 per account in annual compliance costs. The costs include enhancing data processing systems, modifying investor communication systems and media, developing new policies and procedures, and implementing employee training and customer support programs. These amounts do not include any costs incurred by the dealers.[47]

We can suggest two possible alternatives for producing actual cost data for the trailer fees attributable to each client:

1) Approximating the amount, such as by assuming the trailer fee attributable to a client for a fund during a quarter is based on the average of the client's holdings in the fund at the beginning and end of the quarter. Providing cost information on an annual basis should lessen the effect of an anomalistic quarter in which a large amount goes in or out of mutual fund investments. This would produce client-specific data without requiring mutual fund companies to track the data for each client on a daily basis.

2) Showing how much a client would have paid based on a set hypothetical amount held in a fund. We consider this alternative less desirable because it would not allow an aggregation with other fees the client pays to the dealer. It would make the report as a whole more complex and less able to achieve the goal of transparency.

Management fees less trailers: A similar computation issue arises in disclosing to investors the aggregate amount paid over the year as management fees to fund management companies other than the amount passed on to the dealer as trailer fees. The solutions would be similar.

Comment requested
Which is the best method for disclosing costs in relation to trailer fees and management fees?

Back-end loads: Back-end loads present a complication because the payment is made by the investor in a different year than it is received by the dealer. The fund management company amortizes the payment of the up-front commission to the dealer as part of its management fee, charging the investor a redemption fee if the mutual fund units are sold before the end of the amortization period.[48] Including both the full management fee and the up-front commission paid by the fund management company as costs paid by the investor in the report could be confusing and would constitute double counting. Including the up-front commissions paid to dealers in the

---

47 "Mutual Funds – Information on Trends in Fees and Their Related Disclosure", Statement by Richard Hillman Before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, House of Representatives (Mar. 12, 2003), pp. 14-15, http://www.gao.gov/new.items/d03551t.pdf.

48 See Case Study 3 in Appendix F.

aggregate amount paid by investors also could reduce transparency by creating large deviations in the compensation shown as being payable by the investor from year to year even though, from the investor's perspective, those deviations do not exist.

We propose that the aggregate amount shown as paid by an investor to a dealer should not include commissions paid to the dealer for purchases made with a back-end load. This amount should be stated separately as an aggregate amount paid to the dealer as commissions by mutual fund companies. Technically redemption fees are payments made to the fund management company. However, we propose that they be included in the aggregate compensation shown as paid to the dealer which sold the fund to the investor, because the economic reality is that redemption fees are directly attributable to the dealer's sale of the fund. To avoid double counting, those redemption fees could be netted from the aggregate amount shown as paid as commissions by mutual fund companies.

Trading costs and soft dollars: The task of providing investors with transparency in reports of mutual fund investments can also be complicated for the financial services provider by a fund's trading costs, in which various "soft dollar" amounts rebated to the fund manager may be embedded. This disclosure is hindered if trading costs are not included in the Management Expense Ratio (MER). Currently mutual funds only disclose in the prospectus the dollar amount of trading costs, separately from the management fee and MER disclosure. Other public sources of MER data generally do not include this information. One way we suggest to deal with this is to show both the gross return and the net return on a mutual fund investment. The net return would deduct both the MER and the trading costs from the gross return. The trading costs would include the soft dollar amounts.

Selling commissions on public offerings: Some readers may wonder how the general requirement to disclose aggregate compensation costs might apply to fees paid by an issuer to an underwriter or selling group member. Individual representatives would have to disclose any commissions they earn on the sale of the underwritten securities to a client. But we are not proposing that firms, for transparency purposes, allocate a portion of their overall selling commissions or underwriting fees to any particular investor's account.

Analysis of risks. Despite the fundamental importance of understanding risk, account statements rarely communicate this information. Currently there is no regulatory requirement to report risk levels to investors.

We believe there are significant benefits to including a risk analysis in client reports. It would help educate investors about a fundamental aspect of investing. It would likely reduce misunderstandings and protect investors by providing an early warning of a portfolio deviating from its intended risk level. At the same time, it could help protect a representative from investors who claim, once their speculative portfolios have taken a substantial fall, that they had intended to own lower risk investments.

Account statements must provide some form of information about risk.

While we feel strongly that risk should be reported in some form, we recognize that a number of alternative approaches may be acceptable. We have not reached any conclusions on how far we should go in prescribing specific risk measures or presentation methods.

Possible methods of presenting risk include:

1) an overall risk rating for the investment portfolio as a whole
2) a risk rating for each security in the portfolio
3) a graph showing the percentage of the account's holdings that fall within each level of risk used by the financial services provider
4) a risk-adjusted return for the overall portfolio

For each of these presentation methods, one can use different approaches to measuring the riskiness of a security or portfolio. Several quantitative methods commonly used to measure risk are summarized in Appendix E. A variety of more subjective methods, perhaps based on a combination of quantitative and non-quantitative analyses, are also used.

We have not reached any conclusions on how far we should go in prescribing specific risk measures or presentation methods. Prescription could achieve consistency across the industry, and therefore simplicity and comparability for financial services providers and investors. On the other hand, our ongoing consultation may reveal that it is not realistic to expect the industry to reach a consensus. In that case, we as regulators might not attempt to specify anything beyond a general duty to present risk information to investors in a good faith, meaningful, technically defensible form.

Obligations to report risk would vary with the three relationship types.

- **Self-Managed accounts:** Investors would receive risk information on the individual securities in their accounts, but not on the portfolio as a whole.
- **Advisory accounts:** These investors rely on their financial services provider for advice and information to support their decisions. Their account statements should include information on the risk of both individual securities and the complete portfolio. Statements should also compare the account's current risk level to the target risk level set in the Fair Dealing Document.
- **Managed-For-You accounts:** Investors who entrust decisions to a discretionary manager do not rely on detailed information such as the risk level of each security. Nevertheless, requiring the financial services provider to report risk on an overall portfolio or asset class basis might serve as a useful check on the adviser, for both the investor and the firm.

We discuss the duty to monitor risk levels and other aspects of an account on an ongoing basis in the next section.

Comment requested

Are the four risk presentation methods above the most suitable for achieving our objectives?

Which specific risk measures (described in Appendix E) might be suitable? Which are the most feasible for firms to use? What level of precision is reasonable?

How refined should the risk categories be? For example, would a scale of "high, medium, or low risk" be sufficient, or are more categories necessary?

How frequently should we require risk information to be provided to investors?

Q: Will individual investors be able to understand all of the risk measures you're proposing to require in reports?

A: This is one of the issues on which we are hoping to receive comments. Among the comments we've already received on the website, a number of advisers believed investors would have difficulty with these risk measures. The individual investors who commented did not address this point.

The sophistication level of individual investors varies widely. We have proposed some risk measures that could be useful to investors. We leave it to firms to determine how best to communicate them.

Account monitoring responsibilities

Monitoring refers primarily to a financial services provider's duty to periodically review an account for its continued suitability to meet the client's objectives. Such reviews may uncover a need to rebalance the portfolio, or to buy or sell specific securities as a result of recent news or price movements. Monitoring activities may also include client meetings, non-portfolio financial advice (e.g. insurance, tax or estate planning), portfolio warnings and sell recommendations.

> ***The relationship type would determine who is responsible for monitoring an account, and the nature of the responsibilities.***

Specifically, the responsibilities for each type of relationship would be as follows.

- **Self-Managed accounts:** Monitoring responsibilities rest entirely with the investor; this is a fundamental characteristic of the Self-Managed relationship. A financial services provider may volunteer to perform specified monitoring activities for customer service reasons, but it would not be a regulatory requirement.
- **Advisory accounts:** The financial services provider must monitor the account for continued compliance within the parameters set out in the Fair Dealing Document, particularly the portfolio's intended level of risk. A representative should recommend periodic rebalancing where appropriate. All other monitoring activities – including the financial services provider's duty to warn clients of important developments, and the frequency of meetings and other communications – would be left for the parties to decide upon, and to record in their Fair Dealing Document.

- **Managed-For-You accounts:** The financial services provider continues to have full responsibility for managing the account under its fiduciary duty to the investor. Regular monitoring is assumed.

Our main concern here is that investors know what to expect. For example, Self-Managed investors should be aware that there is no one but themselves monitoring their account.

We note that there are existing rules in place dealing with account monitoring, including several IDA policies and regulations.

Updating the Fair Dealing Document

The Fair Dealing Document is not a form to be completed once and then filed away. It is a contract that should continue to reflect the key characteristics of the relationship.

> ***The Fair Dealing Document must be updated to reflect any significant changes in investment objectives, service level, or the relationship itself.***

Investor's responsibility. The investor is expected to inform the financial services provider of any significant changes in their circumstances, such as a large inheritance, or a change in marital or employment status. We will not make this a requirement, but in any subsequent disputes, investors who fail to meet this expectation will have limited recourse to the relevant parts of the Fair Dealing Document. Service providers cannot be expected to take account of the information they were never told.

Representative's responsibilities. In general, the onus is on the representative to update the Fair Dealing Document any time there is a fundamental change to what the parties originally agreed. A switch from one relationship type to another would be one such change; a reduction in services offered (such as a decreased frequency of account monitoring) would be another. Perhaps most common would be a scenario where an investor's portfolio no longer matches the objectives or risk levels set out in the Fair Dealing Document. If the parties agree that, in fact, the current portfolio is more appropriate, then they should update the document to reduce uncertainty and prevent potential disputes.

The representative must also inform investors of their responsibility, described above, to give notice of major life changes. This should be done at the account opening stage, and at periodic intervals afterwards – for example, at a yearly meeting or through a clearly visible reminder in the yearly account statement.

Logistics. Any updates to the Fair Dealing Document must be done in writing. If the new document is completed at a face-to-face meeting, the investor must sign it and receive a copy. Otherwise a copy must be mailed to the investor. It will not always be necessary to generate an entirely new document; amendments may take the form of an appendix to the original agreement, or even an initialled, handwritten change. As a contract, the Fair Dealing Document itself should provide for a process to terminate the relationship and close or transfer the account at the option of either party.

By ensuring the Fair Dealing document remains current, the parties will help satisfy the principle of clearly allocating rights and responsibilities.

Q: What happens if it becomes necessary to update the Fair Dealing Document, but the parties cannot agree to new terms?

A: If the parties cannot agree on a fundamental term of the relationship, they may have no choice but to terminate it, *i.e.* to close the account. Less severe alternatives might include switching to a different representative within the same firm, or switching from an Advisory to a Self-Managed relationship.

V. Transition to the Fair Dealing Model

We recognize that some of the changes we contemplate in this Concept Paper would require significant adjustment on the part of Ontario's investment industry. As we continue to develop the Fair Dealing Model, we will do what we can to make the transition as smooth as possible. Specifically, we have set for ourselves the following objectives:

- continue to actively seek industry input
- strive to ensure that the benefits to market participants exceed their implementation costs
- eliminate any existing regulatory requirements that become redundant
- phase in new rules in practical stages, with sufficient notice provided
- provide logistical support, particularly to smaller market participants, wherever possible

Part V details the steps we are taking – either on our own or with industry collaboration – to meet the above objectives.

Cost-benefit analysis

It is the OSC's policy to complete a cost-benefit analysis before introducing any major regulatory initiative. We will only implement the Fair Dealing Model if we believe the total benefits to investors and financial services providers outweigh the total costs.

We have not yet completed our cost-benefit analysis, because many of the specific requirements of the model have not been finalized. In some cases, these requirements will depend on the findings of the Working Groups we are setting up (described below), or the comments we receive on this Concept Paper. Furthermore, we expect that the Working Group participants will identify costs and benefits that will allow us to make more informed estimates in our analysis.

A tool closely related to cost-benefit analysis is impact analysis, which measures the results of a regulatory initiative some time after it has been implemented. It would offer a check on the effectiveness of the Fair Dealing Model. We are committed to developing appropriate performance measures against which we can test whether the model is achieving the outcomes we listed on page 1.

In the discussion titled "Special Case: Third-party compensation" in Part III of this paper, we present three possible regulatory solutions to the problem of compensation bias. Our cost-benefit analysis would include estimates of the impact of those three approaches. Each solution can be expected to have a net positive impact on investor performance. We will compare the investors' benefits to the total costs under both scenarios in order to determine which solution yields the largest net benefit.

We plan to complete two distinct quantitative analyses – an analysis of our compliance cost survey data, and an econometric model of mutual funds.

Compliance cost survey data. The Fair Dealing Model will introduce new regulatory requirements, for which there will be associated compliance costs. But firms should also expect to realize savings from no longer having to comply with requirements that will be eliminated.

Our Chief Economist's Office has completed a detailed survey of compliance costs among Canadian securities registrants. Firms have told us what it currently costs them to comply with a full range of regulatory requirements, including many that are related to the provider-client relationship. Once we have a more specific idea of the requirements that are introduced and replaced by the Fair Dealing Model, we can estimate the resulting changes in costs.

Our cost estimates will measure both one-time and ongoing costs, and will distinguish between small, medium and large firms. If net costs are found to be significantly higher for smaller firms, and the difference is sufficient to create a barrier to entry, we will examine alternatives for reducing costs. For example, firms might be able to share costs by outsourcing some compliance activities to an intermediary.

Econometric model of mutual funds. We are building a model of mutual fund assets under management, asset performance and adviser compensation, using historical data. This model should allow us to examine the relative role of compensation versus previous manager performance in the change in fund assets. If adviser compensation is found to make a larger contribution to the growth in assets under management than fund performance, it would suggest a conflict of interest in the adviser-client relationship. The conclusion one could draw is that representatives' recommendations are biased by the compensation they receive for selling a particular fund, to the detriment of investors. We would attempt to quantify the impact of any such bias on investors.[49]

When estimating the costs of activities carried out by firms, we typically have limited access to data. If any firms have data on their cost structures that they wish to share with us in confidence for this purpose, we would be glad to incorporate that input into our analysis. The result might be a more accurate cost-benefit calculation.

Please contact:

Randall Powley
Chief Economist
Ontario Securities Commission
Telephone: 416-593-8072
Fax: 416-593-3693
E-mail: rpowley@osc.gov.on.ca

49 In Case Study 3 of Appendix F, we also quantify the impact of compensation biases for a single mutual fund. Our calculations show that, over a 15 year period, investors in a $100 million mutual fund could lose over $20 million in potential proceeds.

Harmonization issues: Will the Fair Dealing Model be adopted nationally?

Market participants have made it very clear to us that one of their primary concerns with any securities regulatory reform is harmonization. They are concerned that the Fair Dealing Model would lead to increased fragmentation if it was adopted only in Ontario. The OSC shares the desire for harmonization, and much of the work we do within the Canadian Securities Administrators (CSA) demonstrates this commitment.

Our ultimate goal for the Fair Dealing Model is to see it adopted nationally. This would lead to the best possible harmonization with such other CSA initiatives as the Uniform Securities Legislation project, Passport Registration, and the National Registration Database. But at this point, it remains an OSC initiative. We have made efforts to keep our CSA counterparts informed of the project. No CSA member has committed to adopt the model, nor would we expect them to do so at such an early stage, before this Concept Paper was published.

Complete national adoption is not the only possibility. A jurisdiction that elects not to implement the Fair Dealing Model could still decide, for example, that Ontario-based registrants who comply with it are adequately regulated to satisfy its local requirements. This would be analogous to the way IDA members are exempted from many local provincial rules, or Canadian issuers are deemed to comply with SEC rules under the multijurisdictional disclosure system (MJDS). We are confident that the Fair Dealing Model can meet this kind of test, given that it improves regulatory standards over those that currently exist.

As we continue to develop our ideas, we will work with other jurisdictions to create a final model that most or all of them are comfortable with.

What happens next?

Establishment of Working Groups to tackle implementation issues

We have consulted with a variety of stakeholders throughout the development of this model. Whether obtained through informal discussions, focus groups, or the website, the input we have received has been informative and very useful in shaping our ideas.

Our next step in this process will be to establish several Working Groups, each tasked with a mandate to resolve a specific set of issues. Before we can translate the ideas expressed in this Concept Paper into workable regulations, we need practical feedback on a number of details. We hope to take into account the realities of the marketplace as seen from a range of perspectives. The Working Groups will offer market participants an opportunity to directly shape the further development of the Fair Dealing Model.

The groups we propose to form, and their mandates, are as follows:

- **Advisers' transition issues**. This Working Group will consider how compliance with the Fair Dealing Model impacts individual representatives in their dealings with clients in all three relationship types, in their own business arrangements, and in their relationships with employers, compliance and back office service providers, trade associations, accreditation bodies and regulators.

- **Compliance and legal specialists**. This group will consider the following: the need for changes to firms' compliance systems; any issues surrounding the documentation requirements we've proposed; the likely impact of the Fair Dealing Document and the relationship structure on disputes and litigation; and the feasibility of delegating functions to third-party back office and compliance suppliers.
- **Business strategy**. This group will consider the potential impact of the Fair Dealing Model on industry structure, firms' business activities, revenues, costs, competition, and the servicing of smaller accounts.
- **Information technology specialists**. This group will consider how existing I.T. and back office systems would need to be adapted to support Fair Dealing Model requirements, any new software that might be required, and whether any specific proposals would be infeasible from a technology standpoint for some or all market participants.
- **Investment fund and portfolio managers**. This group will consider ways of calculating performance information, assess our point of sale disclosure proposals, and provide the institutional investors' perspective. It will also evaluate our three alternative approaches to dealing with issues raised by third-party compensation.
- **Investor reporting group**. With a quantitative focus, this group will have consider the most appropriate methods for communicating to investors such concepts as risk, personalized performance, and compensation.

Each Working Group will be comprised primarily of industry members, who will have considerable freedom to devise implementation solutions. The OSC will likely provide meeting space and some staff resources. We expect to hold initial meetings for each group in early 2004, with the timing and frequency of subsequent meetings set by the chairs. We anticipate that each group will require a number of months to fulfill its mandate and report its findings.

A number of volunteers have already agreed to join the Working Groups, but there is room for others. If you wish to participate in a Working Group, or if you would like further information, please contact:

Adele Margis
Administrative Assistant, Capital Markets Branch
Ontario Securities Commission
Telephone: 416-204-8997
Fax: 416-593-3651
E-mail: amargis@osc.gov.on.ca

We also propose to involve investors in planning for the implementation of the model.

A second concept paper will follow

Once the Working Groups are established, our next major milestone will be the publication of a second concept paper, targeted for calendar 2004.

We have chosen to present the Fair Dealing Model in two parts, to allow us to fully develop the main ideas without creating a paper even thicker than the one you're reading. The present paper focuses on the principles governing the relationship between financial services providers and retail investors. The second paper will propose significant reforms to the way we license firms and their individual representatives. One unintended effect of this division is that the major costs to the industry become apparent now, while the major savings will only become clear later.

In this section we preview some of the ideas of the next concept paper. We will continue to consult extensively with industry to refine these ideas.

Problems with existing license categories. A number of costly inefficiencies and gaps arise because we now license financial services providers on the basis of rigid product silos or artificial distinctions between advice and trading. For example:

- Different regulatory requirements apply to firms and individuals engaged in a similar businesses, and often to different business units of the same corporate group.
- Many firms and individual are forced to obtain multiple licenses to provide what is effectively an integrated service offering.
- The OSC alone tracks over 50 different categories and subcategories of registration for firms and individuals already classified as dealers or advisers. Of 1,371 registered firms as at November, 2002, over 600 were registered in at least two categories, and some in four or five.
- Some activities that influence investors' decisions can fall through the cracks and are not subject to clear standards.

This complex web of regulation leads to increased compliance costs that are ultimately passed on to investors. The Fair Dealing Model presents an opportunity to simplify how we set business conduct and proficiency standards.

The solution is to recognize the fundamental similarities in the way various types of financial services providers deal with retail investors. Essentially, they all function as gatekeepers[50] who benefit from people's investment decisions. There is no reason to set different business conduct standards depending on whether someone implements their advice through mutual funds, exchange-traded securities, or segregated funds.

The single service provider license. As part of its general move away from traditional product-based regulation, the Fair Dealing Model would no longer license financial services providers on the basis of the products they offer. Instead, a financial services provider would

---

50 For example, see the reference to registrants as "gatekeepers of the securities industry" in *Cartaway Resources Corporation, et. al.*, British Columbia Securities Commission decision, October, 2000, paragraph 239.

only need a single license, which would impose a clear and consistent set of conduct standards on everyone, based on the principles enunciated in this paper. The license would cover all relevant business activities connected with a particular client. In contrast, the current regime allows gaps whereby key activities such as general personal financial advice are not directly regulated. Firms would no longer need to adopt artificial business structures to fit themselves into a registration category.

Our idea is to establish two kinds of licenses: one for financial services provider businesses, and one for their individual representatives. Only individuals acting on behalf of the business could be licensed in the "representative" category. A "ticket" system would assign proficiency and capital adequacy requirements appropriate for the services and activities to be carried on by the business, and by individuals delivering those services on its behalf. An individual representative could not undertake to deliver a greater range of service than the business they represent. Firms would be responsible for ensuring their representatives meet an acceptable proficiency standard for the services their clients contract for in the Fair Dealing Document.

We envision the "financial services provider business" category being more flexible than the present "dealer" and "adviser" categories, which presume registrants are solely engaged either in executing trades or in managing portfolios. The range of permitted activities would more closely resemble those of an IDA member firm. This category could include groups of individuals who might now be licensed as salespersons. For example, incorporated salespersons now forming independent contractual relationships with sponsoring dealers would likely be licensed as financial services provider businesses, not as salespersons.

Under this licensing model, back office and compliance services could be contracted out to an approved third party. Services listed in the Fair Dealing Document could be subcontracted, so long as the financial services provider business and its CEO took responsibility for all of them.

As a result of this approach, the requirement to register would no longer need to be triggered only by the act of trading securities, or by being in the business of giving advice about specific securities. We could adopt a test designed to target the broad range of firms and individuals who offer securities-related financial services. We are currently thinking about a three-part test: holding out, economic reality of the business and the actual services offered.[51] Meeting any one of them would be sufficient to trigger a requirement to obtain a license. Those who currently register with securities regulators would undoubtedly continue to do so, but there is also a possibility that others would be caught by this test. For example, the dissemination of investment information and advice by the media has become a principle source of revenue, arguably placing the media outlets in a similar position to traditional financial services providers. A second example is promotional seminars used to attract clients, where the speaker is presented as an objective provider of information.

51 We expect that the Uniform Securities Legislation proposed by the Canadian Securities Administrators will provide scope for this three-part licensing trigger.

Q: Would everyone need to write a common exam in order to obtain the single service provider license?

A: No. We have seen assertions that there would be a single entry level exam that would be less rigorous than current requirements – but this has never been proposed by us. Proficiency requirements would be tied to the services offered and contracted for in the Fair Dealing Document. We have not worked out the details, but we do not contemplate that any standards would be lowered. As we do now, we would look to the industry to provide proficiency standards and testing.

Q: Is the Fair Dealing Model "advice-based"?

A: No. The model recognizes the importance of the advice function in retail services, but the underlying theory of the three-part test described above is to treat all those who are in the business of influencing or implementing investor choices the same.

Two of the primary goals for the new licensing regime are simplicity and market access.

Simplicity. Throughout our stakeholder consultations, we have heard very clearly that administrative burden and unnecessary complexity are major concerns for the industry. We are therefore committing to make simplicity a goal of our new licensing model. And we believe the single service provider license regime described above would meet this objective. To recap:

- Firms and individuals would require one license instead of many.
- The applicable business conduct standards would be clearer and more consistent, since they would all derive from the same license.
- Proficiency standards would be based on the actual services contracted for with a particular client, rather than the provider's business title or registration category.
- Individuals would have more flexibility to provide a range of services without obtaining a variety of licenses. (See the Access discussion below.)

Access. Implementation of the Fair Dealing Model would allow us to relax some existing restrictions, thereby opening up the possibility of greater market access for both investors and financial services providers.

Investors would be able to invest in a wider range of securities through a single representative. This is a direct result of the move away from product-based regulation to a more flexible licensing regime. The Fair Dealing Model contemplates an enhanced role for representatives in advisory relationships to assess and filter investment opportunities for their clients. With representatives providing this new layer of reliable investor protection, we can stop restricting investors' access to entire categories of financial instruments. For example, investors might be allowed to purchase exempt securities like privately placed equity and hedge funds directly. Currently, unless someone meets certain criteria as an accredited investor, they can only access such investments through some form of collective vehicle that imposes additional service costs. Similarly, more people would have access through their existing representative to investments like exchange-traded funds.

From the perspective of financial services providers, taking on greater responsibility would allow them to offer a greater variety of services and investment choices to their clients. There might be circumstances where a broader group of representatives and firms could offer discretionary asset management. With a more flexible approach to licensing and the ability to contract out certain services to full service platforms, smaller businesses that only wish to offer retail advice and to place orders for clients might find it cheaper and easier to register in the financial services provider business category than in the current categories. This would allow smaller firms with direct client contact to "own" their client accounts.

Governance and enforcement. Our work on the second concept paper is also intended to prompt a discussion of how the Fair Dealing Model should best be delivered under a system of integrated direct and self-regulation. Governance institutions that could implement the Fair Dealing Model already exist. However, we are introducing a regulatory model that is neither sector- nor product-based, but that imposes consistent conduct standards on all the activities of financial services providers through their client relationships. This opens up possibilities for simplifying and refocusing the existing patchwork of government and non-government regulators and standard setting organizations.

On a very preliminary basis, since we have not yet had the debate, we see complementary benefits from both direct and self-regulation. The challenge is to ensure that they really do complement and support each other, and do not conflict. Direct regulation can ensure uniform conduct standards, and even-handed enforcement of rules, through both oversight powers and direct action. Private sector educators are well positioned to create and administer technical proficiency standards and education and testing processes. Self-regulatory bodies are a source of special expertise. They ensure "industry democracy", i.e. that those whose daily activities are affected by regulatory requirements both have a role in, and take responsibility for, choosing who sets and administers these requirements.

Comment requested

We are anxious for feedback on the optimal governance structure under the Fair Dealing Model. Given that the model is not product-based, we would be particularly interested in engaging groups such as the Joint Industry Group that have broad cross-sectoral representation and a history of dealing with policy issues of common interest.

We need your comments

We encourage all interested market participants to comment on this Concept Paper. We have raised specific issues throughout the paper, in text boxes titled "Comment Requested", but we would appreciate submissions on any aspect of the Fair Dealing Model.

Comments are due by April 30, 2004, and should be submitted care of:

John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Telephone: 416-593-8145
Fax: 416-593-2318
E-mail: jstevenson@osc.gov.on.ca

If you are not sending your comments by e-mail, please send us two copies of your letter, together with a CD or diskette containing your comments (in Microsoft Word format). We will not keep submissions confidential.

If you have any questions about our proposals, you may contact the manager of the Fair Dealing Model project for clarification:

Julia Dublin
Senior Legal Counsel, Capital Markets Branch
Ontario Securities Commission
Telephone: 416-593-8103
Fax: 416-593-3651
E-mail: jdublin@osc.gov.on.ca

Appendices

Appendix A

Sample Fair Dealing Documents

This Appendix includes samples of completed Fair Dealing Documents for Self-Managed, Advisory, and Managed-for-You relationships between our hypothetical financial services provider, BigBank Securities and our hypothetical investor, George.

These samples show proposed minimum content. Firms would be free to tailor these documents to their own circumstances, so long as they included equivalent content.

The Fair Dealing Model website illustrates how an interactive Fair Dealing Document could be built on-line or electronically for each relationship under the button "Fair Dealing Document" in the "Fair Dealing Model" or "How it Works" sections.

Fair Dealing Document

Self-Managed Relationship

This Fair Dealing Document:

1. Sets out the nature of my client relationship (Choice of: Self-Managed, Advisory or Managed-For-You).
2. Gives me the information I need to understand my relationship with my service provider and my role in it, including my responsibilities.

Who is BigBank Securities?

BigBank Securities can invest my money jointly with others in mutual funds. BigBank Securities sells in-house funds of the BigBank group as well as funds provided by independent third parties.

Although BigBank Securities is owned by BigBank, no money, securities or other property held in this account are insured by the Canada Deposit Insurance Corporation (CDIC).

The service provider must give the investor an introduction to the nature of the business entity as a whole. Examples include (1) a conglomerate consisting of a number of distinct service providers, (2) a corporation that makes collective investment decisions for its investors, or (3) a corporation owned by a group of representatives.
To support the investor's initial understanding of the type of entity involved, this section includes up front disclosure about the relationship between the firm and collective investment vehicles. It includes disclosure about the firm's use of proprietary products and whether or not the firm's product range is limited to proprietary products. It must be made clear that CDIC protection applies to deposits only, as this is not well understood by investors.

My Choice of Relationship

☑ Self Managed
☐ Advisory
☐ Managed-For-You

I have chosen a self-managed relationship.

Under that relationship

- I will choose investments on my own.
- BigBank Securities will not give me personal recommendations about my investments, but will act honestly in giving me information and reports about issuers and the market.
- BigBank Securities will make financial planning software available to me.
- BigBank Securities will provide me with ongoing reports on the performance of my portfolio and the compensation I pay to BigBank Securities or which BigBank Securities receives from others in connection with my account.
- BigBank Securities can provide me with advice as to asset allocation among the in-house funds of the BigBank group.

This assumes the client has been provided with an outline of each type of relationship offered by the firm or corporate group and has made an informed choice. This is reflected in the remainder of the Fair Dealing Document. The fee information applicable to each relationship (see "Fee Schedule" below) would also be presented to the client before the choice is made. The description of the nature of each relationship is intended only as a sample and is not an indication of proposed minimum standards.

My Contact

Hal
(654) 386-5701
Hal@bigbank.com

Hal generally can be reached by email every day 24 hours a day and by telephone from 8:00 a.m.-8:00 p.m. Hal may make recommendations about allocating my assets among the in-house funds of the BigBank group. Hal may also provide me with reports prepared by the BigBank group about specific securities. I am prepared to assess the merits of any of those recommendations on my own.

Services Provided

The services provided by the BigBank group are checked below. Some of the checked services are not available with a self-managed account:

- ☑ Acting as my agent in buying or selling securities on stock exchanges
- ☑ Selling me shares in initial public offerings or subsequent public offerings
- ☑ Acting as my agent in taking orders to buy or sell equity instruments not traded on organized markets
- ☑ Acting as my agent in arranging for my money to be invested jointly with others, such as in a mutual fund
- ☑ Taking orders as my agent to buy or sell corporate bonds
- ☑ Taking orders as my agent to buy or sell government bonds
- ☑ Taking my orders for GICs
- ☑ Making personalized recommendations about my investments
- ☑ Giving me reports the BigBank group has prepared on specific investments
- ☐ Giving me reports prepared by other firms on specific investments
- ☐ Sending me newsletters about investments or the markets
- ☑ Making decisions about my investments without consultation (done only with my prior written approval)
- ☐ Acting as my agent in dealing with life insurance companies
- ☐ Acting as my agent in dealing with property and casualty insurance companies
- ☑ Providing me with property and casualty insurance
- ☑ Providing me with objective, integrated and comprehensive advice based on an assessment of my current financial situation and current and future financial needs
- ☐ Planning my estate
- ☐ Preparing my tax returns
- ☑ Acting as my banker
- ☑ Providing trust services

This section must contain a prescribed list of services and indicate which the firm or group provides or does not provide. Showing the investor which services are not provided allows the investor to know (i) which services must be obtained elsewhere, and (ii) which services might not be recommended by the firm because the firm does not provide them.
The prescribed list is only a minimum standard. The firm may supplement it as desired.
According to the FSA's "Reforming Polarisation: Making the market work for consumers" at p. 70, consumer research has shown the approach of ticking certain boxes to be successful in communicating to consumers the things a particular representative or service provider does or does not do.
For a self-managed account, the investor would only be able to choose certain services.

Compensation

BigBank Securities is paid on this type of account by:

☑ A commission on most transactions.
☑ A spread between my price and BigBank Group's price on bond transactions.
☐ A fee based on the size of my account.
☐ An hourly fee.
☐ A flat fee each year.

This section informs the investor about the manner of compensation or, if more than one method is available, the applicable options. The inclusion of the methods not available from the financial services providers in the list informs the investor about the existence of other compensation methods that may be available from other financial services providers. It is contemplated that if the financial services provider is paid by commission, but the representative is not, the financial services provider would wish to state it.

Fee Schedule

Share price of $2.00 or less
1.5% of principal trade
$29.00 minimum

Share price of $2.01 or greater
$29.00 flat fee for orders up to 1,000 shares
and
$0.03/share for orders greater than 1,000 shares

Although included in the samples as sections of the Fair Dealing Document, a financial services provider might prefer to include the fee schedule as a link for an interactive Fair Dealing Document or as a schedule attached at the end of a printed version.
The fee schedule must refer to the existence of applicable fees paid by third parties (*e.g.*, trailing fees, commissions paid in relation to mutual fund sales made with a back-end load, commissions paid for public offerings, and fees paid in relation to take-over bids).
The fee schedule would indicate where fees are negotiable.
The fee schedule can be subject to change as in current practice.

- For each three-month period you remain invested in a mutual fund, BigBank Securities receives a commission from the manager of the fund.
- If you buy shares in a public offering, BigBank Securities receives a commission from the issuer or seller of those shares.
- If you tender your shares to a take-over bid, BigBank Securities receives a payment from the firm making the bid.
- These fees are subject to change at any time. BigBank Securities will inform me of any changes in these fees by email and will show the commissions then payable on its website. I will be informed of the amount of commission payable on my trades whenever I place an order.
- BigBank Securities will pay me daily interest on any cash balance held in my account at the rate then stated on its website.

Who I am

This section is not intended to change the standard information currently obtained by financial services providers.

Name: George Investor
Address: 123 Main, Notown, ON Q3W 5T7
Phone: (654) 765-6544
Email address: ginvestor@hotmail.com
SIN: 001 001 001
Birth Date: 05/28/57

Receiving Annual Reports and Other Material

It is proposed to substantially shorten the disclosure currently provided to investors concerning the delivery of material to non-registered shareholders by asking investors the essential questions about the receipt of materials without providing a description of the legal background. This section may be omitted if inapplicable.

For securities for which I do not hold certificates registered in my name, I want to receive copies of annual reports and all other material sent to security holders. I consent to my name, address, holdings and preferred language of correspondence to be provided to issuers of securities I hold or to others permitted to send out materials under securities laws.

My Responsibilities

This section clarifies to the investor the investor's own responsibilities with respect to the account. Certain responsibilities would have to be stated while others could be added at the firm's option.
The contents of this section vary significantly among the three types of relationships.

- I am responsible for all trading instructions given by me or by persons I have authorized to trade on my behalf. I will keep my passwords absolutely confidential and ensure that they are never disclosed to anyone else at any time.
- When I place an order online, it is not reviewed by any person.
- I am responsible for all my trading decisions and understanding what I am doing. I am also responsible for verifying whether my order has been received.
- If I try to place an order and I do not receive confirmation that it has gone through, I am responsible for double checking its status before placing the order again.
- I will check my confirmations and let BigBank Securities know of any problems within 10 business days.
- I am responsible for looking at the statements I receive from BigBank Securities and for checking that the transactions shown on my statement for each period correspond to my understanding of what I did. I will let BigBank Securities know as soon as I can of any discrepancies and within 45 days of the date of the statement at the latest.
- Although BigBank Securities will update any foreign content limit of my accounts on a daily basis, it is my responsibility to ensure that I do not do any transactions that would cause that limit to be exceeded.
- If BigBank Securities sends me a communication asking for a response, I will respond as requested.
- I understand and accept my responsibilities in a self-managed relationship.

What BigBank Securities Will Do for Me

This section seeks to avoid misunderstandings by communicating to the investor the responsibilities of the firm and the limitations on those responsibilities. Certain responsibilities would have to be stated while others could be added at the firm's option. The contents of this section vary significantly among the three types of relationships.

- BigBank Securities will always deal with me fairly, honestly and in good faith.
- BigBank Securities will give me the information I need for buying and selling securities.
- BigBank Securities will send me prompt confirmation of my investments.
- BigBank Securities will send me summary statements about my account every month. My statements will show what has happened in my account since my last statement. They will also give me information about the performance of my account and the overall risk level of my account. At the end of each year, BigBank Securities will give me information about the total amount of fees and expenses I have paid during the year.
- The statements that BigBank Securities sends to me and my online statement, updated daily, will show the foreign content in any account I hold that has a foreign content limit.
- BigBank Securities will respond promptly to any questions or complaints I may have.

Information BigBank Securities Will Give Me About Investing

This section allows the investor to choose the information sheets they want. The securities (general) information sheet might be made a compulsory disclosure item, at least for those who have not yet received it, due to its general applicability and the importance of some of its contents, such as the discussion about risk. We propose eventually to produce a complete set of sample information sheets.

BigBank Securities will offer me information sheets about investing in securities generally and particular types of investments. These sheets are designed to give a basic introduction to a subject and alert me to the risks and limitations of the investments. BigBank Securities strongly recommends that I read the sheets they give me on any subject with which I am unfamiliar. If there is anything I do not understand in one of the sheets, I can ask BigBank Securities.

Whenever I consider making a new type of investment, BigBank Securities will have a sheet on it for me.

I have indicated below which information sheets I want mailed to me.

- [x] Securities (General)
- [x] Equities
- [ ] Bonds
- [x] Mutual funds
- [ ] Income trusts
- [ ] Exchange traded funds
- [ ] Options
- [ ] Limited partnerships

What To Do if I Have a Problem

If I have a problem with this account, I understand that I should contact [BigBank Securities Compliance Dept. contact]. If I am not satisfied, I can contact [identify principal regulator or "Compliance Inc."]. I can also take my case to court or to arbitration.

Investors need to be given information in a way that encourages them to raise complaints and concerns about their representatives with the Branch Manager or higher. Clients' reluctance to complain beyond the level of the representative can contribute to compliance problems going undetected until a crisis occurs.

In Part V of the Concept Paper we refer to the single service provider license and the notion of outsourcing compliance, which will be developed further in our second Concept Paper.

Finalize the Fair Deal

I and BigBank Securities have agreed to the contents of this Fair Dealing Document.

I have asked for a copy of this Fair Dealing Document to be sent to me in the mail. In the meantime I can access its contents online for one month.

Account no.: 12345678

Date: October 1, 2003

The investor has the option of entering into the agreement right away, going back to make revisions, or first printing off and reading a hard copy. The Fair Dealing Document would be signed by both the representative and the client if a hard copy is prepared in a person-to-person setting. The parties would agree to the Fair Dealing Document electronically if it is completed over the Internet.

Signature of Client ______________________ Date ______________

Signature of BigBank Representative ______________________ Date ______________

BIGBANK SECURITIES

Fair Dealing Document

Advisory Relationship

This Fair Dealing Document:

1. Sets out the nature of my client relationship (Choice of: Self-Managed, Advisory or Managed-For-You).
2. Gives me the information I need to understand my relationship with BigBank Securities and my role in it, including my responsibilities.
3. Provides a framework for investing my money, unless I choose a self-managed relationship. In order for me to receive recommendations or have decisions made on my behalf, BigBank Securities needs information to help it know me better and understand my current situation and long-term goals. In creating this Fair Dealing Document, BigBank Securities wishes to create reasonable expectations and guidelines for my portfolio. It is not a guarantee.

Who is BigBank Securities?

BigBank Securities can invest my money jointly with others in mutual funds. BigBank Securities sells in-house funds of the BigBank group as well as funds provided by independent third parties.

Although BigBank Securities is owned by BigBank, no money, securities or other property held in this account are insured by the Canada Deposit Insurance Corporation (CDIC).

The investor must be given an introduction to the service provider's business as a whole. Examples include (1) a conglomerate consisting of a number of distinct service providers, (2) a corporation that makes collective investment decisions for its investors, or (3) a corporation owned by a group of representatives.
To support the investor's understanding of the type of service provider, this section should include up-front disclosure about the relationship between the firm and collective investment vehicles. It includes disclosure about the firm's use of in-house asset management vehicles and whether or not the firm only offers proprietary investments.
It must be made clear that CDIC protection applies to deposits only, as this is not well understood by investors.

My Choice of Relationship

☐ Self Managed
☑ Advisory
☐ Managed-For-You

I have chosen an advisory relationship.

Under that relationship:

- BigBank Securities will provide me with the level of financial advice I choose based on an analysis of my personal circumstances and financial objectives as I disclose them to BigBank Securities.
- I am expected to keep BigBank Securities advised of any significant changes in my circumstances or objectives.
- BigBank Securities will give me expert advice on the composition of my portfolio, my investment strategy, and other issues affecting my financial objectives. BigBank Securities will at all times exercise the judgment of a reasonable expert and act in my best interests in advising me on my account. BigBank Securities' advice and recommendations will not be self-serving.
- BigBank Securities will monitor my account and may recommend adjustments to my portfolio as a result of changes in my personal circumstances, changing views of the market, or the need to rebalance my investments.
- BigBank Securities will provide me with ongoing reports on the performance of my portfolio and the compensation I pay to BigBank Securities or which it receives from others in connection with my account.
- If I wish to make investments BigBank Securities has not recommended to me, BigBank Securities will only make them for me if they consider them suitable to my personal circumstances and overall portfolio.
- BigBank Securities will not make investments for me without my prior approval, unless I give them written permission beforehand.

> This assumes the client has been provided with an outline of each type of relationship offered by the firm or group and has made an informed choice. This is reflected in the remainder of the Fair Dealing Document. The fee information applicable to each relationship (see "Fee Schedule" below) would also be presented to the client before the choice is made.
> The description of the nature of each relationship is intended only as a sample and is not an indication of proposed minimum standards.

My Adviser

Jane Jones

(654) 386-5792

jjones@bigbank.com

Jane or her assistant can be reached any business day between 8:30 a.m. and 5:00 p.m.

Adviser's Qualifications

Jane has passed examinations qualifying her to do the following:

1. Provide recommendations about securities I might buy and the prices of those securities.
2. Provide recommendations about selecting persons to make my investment decisions and how much of my money to give to each.
3. Provide me with objective, integrated and comprehensive advice based on an assessment of my current financial situation as well as current and future financial needs.
4. Provide any of the services which I have checked off below.

At a minimum this section informs the advisory or managed-for-you investor about the services the firm, and the client's representative or group of representatives and its representative are qualified to provide. It could provide greater detail about the representative's areas of experience and expertise, as the firm or group chooses. In the sample, it is assumed Jane is going to provide all the checked services.

Services Provided

The services that I select from those offered by BigBank Securities are checked below.

- ☑ Acting as my agent in buying or selling securities on stock exchanges
- ☑ Selling me shares in initial public offerings or subsequent public offerings
- ☑ Acting as my agent in taking orders to buy or sell equity instruments not traded on organized markets
- ☑ Acting as my agent in arranging for my money to be invested jointly with others, such as in a mutual fund
- ☑ Taking orders as my agent to buy or sell corporate bonds
- ☑ Taking orders as my agent to buy or sell government bonds
- ☑ Taking my orders for GICs
- ☑ Making personalized recommendations about my investments
- ☑ Giving me reports the BigBank group has prepared on specific investments
- **N/A** Giving me reports prepared by other firms on specific investments
- ☐ Sending me newsletters about investments or the markets
- ☑ Making decisions about my investments without consultation (done only with my prior written approval)
- **N/A** Acting as my agent in dealing with life insurance companies
- **N/A** Acting as my agent in dealing with property and casualty insurance companies
- **N/A** Providing me with property and casualty insurance
- ☐ Providing me with objective, integrated and comprehensive advice based on an assessment of my current financial situation and current and future financial needs
- ☑ Planning my estate
- ☐ Preparing my tax returns
- ☑ Acting as my banker
- ☑ Providing trust services

This section will contain a prescribed list of services and indicate which the firm or group provides or does not provide. Showing the investor which services are not provided allows the investor to know (i) which services, if desired, must be obtained elsewhere, and (ii) which services might not be recommended by the financial services provider because the financial services provider does not provide them.
The prescribed list is only a minimum standard. The financial services provider may supplement it as desired.
According to the FSA's "Reforming Polarisation: Making the market work for consumers" at p. 70, consumer research has shown the approach of ticking certain boxes to be successful in communicating to consumers the things a particular representative or service provider does and does not do.

Compensation

BigBank Securities is paid on this type of account by:

- ☐ A commission on most transactions.
- ☑ A spread between my price and BigBank group's price on bond transactions.
- ☑ A fee based on the size of my account.
- ☐ An hourly fee.
- ☐ A flat fee each year.

This section informs the investor about the manner of compensation or, if more than one method is available, the applicable options. Including methods not available from the firm or group in the list informs the investor about the existence of other compensation methods that may be available from other firms.
It is contemplated that if the firm will receive commissions but the representative will not, the firm should disclose this.

Fee Schedule

Annual fee of 1% of average portfolio value, subject to a minimum of $500 per year. BigBank Securities will rebate to my account all fees and commissions paid to it by third parties.

BigBank Securities will pay me daily interest on any cash balance held in my account at the rate then stated on its website.

Although included in the samples as sections of the Fair Dealing Document, a firm might prefer to include the fee schedule as a link for an interactive Fair Dealing Document or as a schedule attached at the end of a printed version.
The fee schedule must identify applicable fees paid by third parties (*e.g.*, trailing fees, commissions paid in relation to mutual fund sales made with a back-end load, commissions paid for public offerings, and fees paid in relation to take-over bids).
The fee schedule would indicate where fees are negotiable.
The fee schedule can be subject to change as in current practice.

Who I am

Name: George Investor
Address: 123 Main, Notown, ON Q3W 5T6
Phone: (654) 765-6544
Email address: ginvestor@hotmail.com
SIN: 001 001 001
Birth Date: 05/28/57

This section is not intended to change the standard information currently obtained by firms.

My Investment Goals

The purpose of the following information is for BigBank Securities to understand my investment goals. The information is needed by BigBank Securities to give me appropriate recommendations for the investments in my account.

This section sets a standard for representatives to know their clients and better understand their financial situation and goals. This should reduce the extent of misunderstandings among representatives and their clients and the frequency of unsuitable recommendations. Although higher than the present minimum standard, it is comparable to the standard adopted by many representatives today. The questions are designed to be relatively specific and objective, and to avoid as much as possible checking off boxes whose meaning is poorly defined and understood.

Although the Fair Dealing Document provided to an investor must meet certain minimum standards, the investor is entitled to choose to not respond to all the questions. For example, an investor might be looking to a particular representative to help only in selecting stocks using a small portion of the investor's assets, without any intention that the representative would have an understanding of the investor's overall financial goals.

For this and the next section, the representative can use judgement to leave out certain material as appropriate. For example, for a young investor making an initial small contribution to an RRSP, the representative could consider it premature to assess the investor's financial needs at retirement. For an investor who only has an RRSP account, questions about financial needs other than for retirement might be immaterial.

Financial Needs

I plan to use investments in this account for the following:

- Retirement: ☑ Yes ☐ No
  Minimum years to retirement: 25
  Amount anticipated to be saved for retirement: $250,000
  Income level expected excluding effects of inflation: $35,000
- Buying a house or cottage: ☑ Yes ☐ No
  Minimum years until purchase: 2
  Expected amount needed from this account: $20,000
- Buying a car or similar major purchase: ☐ Yes ☑ No
- Education: ☐ Yes ☑ No
- Other: ☐ Yes ☑ No
- Amount needed for emergency purposes (accessible within a few days): $3,000
- Number of dependents: None

Income

Amount I earn each year from work	$77,000
Stability of income	Very stable salary
Amount I earn annually from other sources	None, except anticipated investment income from this account.

Assets

Total amount I have available for investment (excluding real estate and deducting related debt)	$80,000
Types of investment intended to be kept outside this account	None
Amount I have deposited with financial institutions	$47,000
The approximate value of my real estate (deducting mortgages)	$127,000
Other assets worth more than $10,000 (e.g., an art collection)	None
Total amount of any personal loans (not including mortgages)	None
Total amount of my credit card debt	$1,400

I am a member of a defined benefit pension plan.

Experience

Years of investing experience (not including receiving interest on deposits and savings bonds): 16

I have purchased the following before:

Cash and equivalents:
- Treasury bills

Fixed income:
- Savings bonds
- GICs
- Bonds

Equity:
- Common stock

Insurance:
- Term life insurance

Experience with investments outside Canada:
- Fixed income, not in Canadian dollars
- Equity in foreign companies

Risk

Completed form reflects process where representative must take client through a meaningful discussion of risk tolerance and expectations.

Minimum percentage of this account that I want invested with a low risk of loss of principal	75%
Maximum percentage of this account that I want invested in a way that might expose my principal to a high level of risk	10%
Percentage loss of principal at which I would like BigBank Securities to call me about reviewing this account	5%

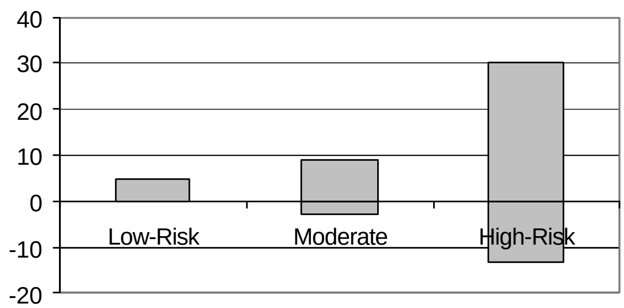
I am willing / <u>am not willing</u> to accept short-term price volatility in order to try to get higher returns.

I do /<u>do not</u> contemplate borrowing money in connection with my investments in this account (buying on margin or selling short).

I would like my investments to roughly fall into those categories as follows:

Low risk: 75%
Medium risk: 15%
High risk: 10%

The following chart shows the range of returns anticipated from a low, medium or high risk portfolio:



It is recognized that some representatives can better elicit an investor's level of risk through other means, such as a risk evaluation questionnaire or conversations with the investor. The representative may use alternatives to the questions in the Fair Dealing Document dealing with the level of risk.

Taxation

I do not have particular tax goals for this account (e.g. income splitting).

General

Other comments about how I prefer my money to be invested: None

Completeness

None of my answers are incomplete.

Initial Approach to Investing for the Account

Overall account objectives	Predominantly low-risk income
Adviser's assessment of investor's tolerance for risk	Low
Desired rate of return (could be stated in terms of a range)	3-5% above inflation rate
Types of investments intended for initial inclusion in the account	Mutual funds, exchange traded funds, bonds and treasury bills
Diversification goal	Higher risk investments to be in foreign securities
Any restrictions on investments	None
Initial asset allocation	Treasury bills Corporate bonds or bond mutual funds Diversified equity mutual funds or index securities Emerging markets equity fund
Treatment of investments switched into this account	Switch in keeping with the purpose of this portfolio

This is the equivalent of the Investment Policy Statement provided by some firms. This section is important for helping establish an initial meeting of the minds between the investor and the representative concerning the manner in which an advised or managed-for-you account will be invested. Firms may modify the items in accordance with their methods for serving investors and investors' preferences so long as some form of investing framework is agreed.

Initials of adviser: ________________

Initials of investor: ________________

Receiving Annual Reports and Other Material

For securities for which I do not hold certificates registered in my name, I want to receive copies of all materials sent to security holders. I consent to my name, address, holdings and preferred language of correspondence to be provided to the issuers of securities I hold or to others permitted to send out materials under securities laws.

It is proposed to substantially reduce mandatory disclosure to non-registered shareholders about delivery of issuer material. Investors would be asked the essential questions, but would not be provided with a lengthy description of the legal background.

My Responsibilities

This section alerts the investor to his own responsibilities with respect to the account. Certain responsibilities would have to be stated. A firm could add others. The contents of this section vary significantly among the three types of relationships.

- I will provide information to BigBank Securities with reasonable accuracy. I understand that the ability of BigBank Securities to help me reach my overall investment goals also depends on the completeness of the information I provide.
- Before I make an investment, I will let BigBank Securities know if I do not understand it so that BigBank Securities can answer my questions or let me know if a less complicated investment is available.
- I will update BigBank Securities promptly about any change in my financial needs or investment goals.
- I will look at the statements I receive from BigBank Securities. I will check that the list of transactions shown for each period corresponds to my understanding of what was done. I will let BigBank Securities know as soon as I can about any discrepancy.
- If I make an investment in this account that BigBank Securities did not recommend to me, it is my responsibility to fully investigate it. Although BigBank Securities will tell me if it does not appear to meet the objectives for this account, BigBank Securities is not responsible for being familiar with it. It is also my responsibility to decide when it should be sold.
- If BigBank Securities sends me a communication asking for a response, I will respond as requested.
- If I might want action to be taken on my account when I am not at my usual location and I have not given BigBank Securities prior instructions, I will contact BigBank Securities or give it contact information.

What BigBank Securities Will Do for Me

This section seeks to avoid misunderstandings by communicating to the investor the responsibilities of the firm and the representative or group and the limitations on those responsibilities.
Certain responsibilities would have to be stated. A firm could add others as desired.
The contents of this section vary significantly among the three types of relationships.

- Jane Jones will act on behalf of BigBank Securities as my agent. She will act on my behalf in making investments for me. Her principal responsibility in helping me make investments must be to me. Both she and BigBank Securities will always deal with me fairly, honestly and in good faith.
- When BigBank Securities recommends an investment to me, BigBank Securities will give me the information I need to make an investment decision. That includes making sure I understand the costs involved and the risks of the investment. BigBank Securities will answer my questions about my investments. If I do not understand an investment, BigBank Securities will let me know about less complicated alternatives. If I make an investment BigBank Securities has recommended to me, BigBank Securities will tell me when I should consider selling the investment.
- When I make an investment in this account that BigBank Securities has not recommended to me, BigBank Securities will tell me if it does not consider it to fit the objectives for this account.
- BigBank Securities will send me prompt confirmation of my investments.
- BigBank Securities will send me summary statements about my account at least every three months. My statements will show what has happened in my account since my last statement. They will also give me information about the performance of my account, and the overall risk level of my account. At the end of each year, BigBank Securities will give me information about the total amount of fees and expenses I have paid during the year.
- BigBank Securities will review my account with me each year. When BigBank Securities does so, it will ask me about any changes in my investment goals.
- BigBank Securities will provide ongoing monitoring of my portfolio and make recommendations for rebalancing when appropriate.
- BigBank Securities will respond promptly to any questions or complaints I may have.
- BigBank Securities will not make any purchases or sales for this account without my instructions.

Information BigBank Securities Will Give me About Investing

BigBank Securities will offer me information sheets about investing in securities generally and particular types of investments. These sheets are designed to give a basic introduction to a subject and alert me about the risks and limitations of the investments. BigBank Securities strongly recommends that I read the sheets they give me on any subject with which I am unfamiliar. If there is anything I do not understand in one of the sheets, I can ask Jane Jones.

Whenever I consider making a new type of investment, BigBank Securities will have a sheet on it for me.

I have indicated below which information sheets I want mailed to me.

- ☑ Securities (General)
- ☑ Equities
- ☑ Bonds
- ☑ Mutual funds
- ☑ Income trusts
- ☑ Exchange traded funds
- ☐ Options
- ☐ Limited partnerships

This section allows the investor to choose the information sheets they want. Accepting the securities (general) information sheet could be made compulsory for those who have not yet received it, given its general scope and the importance to a new investor of its contents, such as the discussion about risk.

What To Do If I Have a Problem

- If I have a problem with this account, I understand that I may first speak to Jane Jones and her immediate supervisor.
- If I am not satisfied, I understand that I should contact [BigBank Securities Compliance Dept. Contact].
- If I am still not satisfied, I can send a written complaint to: [principal regulator or Compliance Inc.]. I can also take my case to court or to arbitration.

Investors need to be given the necessary information and encouraged to raise complaints and concerns about their representatives with the Branch Manager or higher. Clients' reluctance to complain beyond the level of the representative can contribute to compliance problems going undetected until a crisis occurs.

In Part V of the Concept Paper we refer to the single service provider license and the notion of outsourcing compliance, which will be developed further in our second Concept Paper.

Finalize the Fair Deal

BigBank Securities and I have agreed to the contents of this Fair Dealing Document. I have received a copy of this Fair Dealing Document at the offices of BigBank Securities/ will receive a copy from BigBank Securities by __________.

The investor has the option of entering into the agreement right away, going back to make revisions, or first printing off and reading a hard copy. The Fair Dealing Document would be signed by both the representative and the client if a hard copy is prepared in a person-to-person setting. The parties would agree to the Fair Dealing Document electronically if it is completed over the Internet.

Account no.: 12345679

Date: October 1, 2003

______________________________	__________________
Signature of Client	Date
______________________________	__________________
Signature of BigBank Representative	Date

Fair Dealing Document

Managed-For-You Relationship

This Fair Dealing Document:

1. Sets out the nature of my client relationship (Choice of: Self-Managed, Advisory or Managed-For-You).
2. Gives me the information I need to understand my relationship with BigBank Securities and my role in it, including my responsibilities.
3. Provides a framework for investing my money. In order for me to receive recommendations or have decisions made on my behalf, BigBank Securities needs information to help it know me better and understand my current situation and long-term goals. In creating this Fair Dealing Document, BigBank Securities wishes to create reasonable expectations and guidelines for my portfolio. It is not a guarantee.

Who is BigBank Securities

BigBank Securities can invest my money jointly with others in mutual funds. BigBank Securities sells in-house funds of the BigBank group as well as funds provided by independent third parties.

Although BigBank Securities is owned by BigBank, no money, securities or other property held in this account are insured by the Canada Deposit Insurance Corporation (CDIC).

The investor must be given an introduction to the service provider's business as a whole. Examples include (1) a conglomerate consisting of a number of distinct service providers, (2) a corporation that makes collective investment decisions for its investors, or (3) a corporation owned by a group of representatives.
To support the investor's understanding of the type of service provider involved, this section includes up front disclosure about the relationship between the firm and collective investment vehicles. It includes disclosure about the firm's use of in-house asset management vehicles, and whether or not the firm only offers proprietary investments. It must be made clear that CDIC protection applies to deposits only, as this is not well understood by investors.

My choice of relationship

☐ Self Managed
☐ Advisory
☑ Managed-For-You

I have chosen a managed-for-you relationship.

Under that relationship:

- BigBank Securities will make investment decisions for this account without consulting me in advance.
- BigBank Securities will at all times exercise the judgment of a reasonable expert and act in my best interests in making investments for my account.
- Investment decisions made by BigBank Securities will not be self-serving. They will take into account my personal circumstances and financial objectives as I disclose them to BigBank Securities.
- I am expected to keep BigBank Securities advised of any significant changes in my circumstances or objectives.
- BigBank Securities will provide me with ongoing reports on the performance of my portfolio and the compensation I pay to BigBank Securities or which it receives from others in connection with my account.

This assumes the client has been provided with an outline of each type of relationship offered by the firm or corporate group and has made an informed choice. This is reflected in the remainder of the Fair Dealing Document. The fee information applicable to each relationship (see "Fee Schedule" below) would also be presented to the client before the choice is made. The description of the nature of each relationship is intended only as a sample and is not an indication of proposed minimum standards.

My Adviser

Jane Jones

(654) 386-5792

jjones@bigbank.com

Jane or her assistant can be reached any business day between 8:30 a.m. and 5:00 p.m.

Adviser's Qualifications

Jane has passed examinations qualifying her to do the following:

- Provide me with objective, integrated and comprehensive advice based on an assessment of my current financial situation as well as current and future financial needs.
- Manage my portfolio on my behalf.

At a minimum this section informs the advised or managed-for-you investor about the services the representative (or group) is qualified to provide. It could provide greater detail about the representative's areas of experience and expertise.

Services Provided

This section must contain a prescribed list of services and indicate which the group provides or does not provide. Showing the investor which services are not provided allows the investor to know (i) which services, if desired, must be obtained elsewhere, and (ii) which services might not be recommended by the firm because the firm or group does not provide them. The prescribed list is only a minimum standard. The firm may supplement it as desired.
According to the FSA's "Reforming Polarisation: Making the market work for consumers" at p. 70, consumer research has shown ticking certain boxes to be successful in communicating to consumers the things a particular representative or service provider does and does not do.

The services provided by the BigBank group are checked below. Some of the checked services are not available with this account. Those would include taking orders for trades with a Managed-For-You account.

- ☑ Acting as my agent in buying or selling securities on stock exchanges
- ☑ Selling me shares in initial public offerings or subsequent public offerings
- ☑ Acting as my agent in taking orders to buy or sell equity instruments not traded on organized markets
- ☑ Acting as my agent in arranging for my money to be invested jointly with others, such as in a mutual fund
- ☑ Taking orders as my agent to buy or sell corporate bonds
- ☑ Taking orders as my agent to buy or sell government bonds
- ☑ Taking my orders for GICs
- ☑ Making personalized recommendations about my investments
- ☑ Giving me reports the BigBank group has prepared on specific investments
- ☐ Giving me reports prepared by other firms on specific investments
- ☐ Sending me newsletters about investments or the markets
- ☑ Making decisions about my investments without consultation
- ☐ Acting as my agent in dealing with life insurance companies
- ☐ Acting as my agent in dealing with property and casualty insurance companies
- ☑ Providing me with property and casualty insurance
- ☑ Providing me with objective, integrated and comprehensive advice based on an assessment of my current financial situation and current and future financial needs
- ☐ Planning my estate
- ☐ Preparing my tax returns
- ☑ Acting as my banker
- ☑ Providing trust services

Compensation

BigBank Securities is paid on this type of account by:

- ☐ A commission on most transactions.
- ☑ A spread between my price and BigBank group's price on bond transactions.
- ☑ A fee based on the size of my account.
- ☐ An hourly fee.
- ☐ A flat fee each year.

This section informs the investor about the manner of compensation or, if more than one method is available, the applicable options. The inclusion of the methods not available from the financial services provider in the list informs the investor about the existence of other compensation methods that may be available from other financial services providers.
It is contemplated that if the financial services provider is paid by commission, but the representative is not, the financial services provider would wish to state it

Fee Schedule

1.25% of the first $500,000 in portfolio value, and 1% on the amount over $500,000.

BigBank Securities will pay me daily interest on any cash balance held in my account at the rate then stated on its website.

Although included in the samples as sections of the Fair Dealing Document, a firm might prefer to include the fee schedule as a link for an interactive Fair Dealing Document or as a schedule attached at the end of a printed version.
The fee schedule must identify applicable fees paid by third parties (*e.g.*, trailing fees, commissions paid in relation to mutual fund sales made with a back-end load, commissions paid for public offerings, and fees paid in relation to take-over bids).
The fee schedule would indicate where fees are negotiable.

Who I am

Name: George Investor
Address: 123 Main, Notown, ON Q3W 5T7
Phone: (654) 765-6544
Email address: ginvestor@hotmail.com
SIN: 001 001 001
Birth Date: 05/28/57

This section is not intended to change the standard information currently obtained by firms.

My Investment Goals

The purpose of the following information is for BigBank Securities to understand my investment goals. The information is needed by BigBank Securities to give me appropriate recommendations for the investments in my account.

Financial Needs

I plan to use investments in this account for the following:

- Retirement: ☑ Yes ☐ No
  Minimum years to retirement: 25
  Amount anticipated to be saved for retirement: $1,000,000
  Income level expected excluding effects of inflation: $60,000

- Buying a house or cottage: ☑ Yes ☐ No
  Minimum years until purchase: 2
  Expected amount needed from this account: $50,000

- Buying a car or similar major purchase: ☐ Yes ☑ No

- Education: ☑ Yes ☐ No
  Minimum years until enrolment: 3
  Expected amount needed from this account: $20,000

- Other: ☐ Yes ☑ No

- Amount needed for emergency purposes (accessible within a few days): $10,000

- Number of dependents: One

This section raises the minimum standard for representatives to know their clients and better understand their financial situation and goals. This should reduce the extent of misunderstandings among representatives and their clients and the frequency of unsuitable recommendations. The questions are designed to be relatively specific and objective. We want to avoid as much as possible an investor checking off boxes whose meaning is poorly defined and understood by either investor or adviser. Although the Fair Dealing Document provided to an investor must meet certain minimum standards, the investor is entitled to choose to not respond to all the questions. For example, an investor might be looking to a particular representative to help only in selecting stocks using a small portion of the investor's assets, without any intention that the representative would have an understanding of the investor's overall financial goals.
For this and the next section, the representative can use judgement to leave out certain material as appropriate. For example, for a young investor making an initial small contribution to an RRSP, the representative could consider it premature to assess the investor's financial needs at retirement. For an investor who only has an RRSP account, questions about financial needs other than for retirement might be immaterial.

Income

Amount I earn each year from work	$100,000
Stability of income	Earnings can vary each year by about 20% from average
Amount I earn annually from other sources	None

Assets

Total amount I have available for investment (excluding real estate and deducting related debt)	$300,000
Types of investments intended to be kept outside this account	None
Amount I have deposited with financial institutions?	$47,000
Approximate value of my real estate (deducting mortgages)	$227,000
Other assets worth more than $10,000 (e.g., art collection)	None
Total amount of any personal loans (not including mortgages)	None
Total amount of my credit card debt	None

I am not a member of a pension plan.

Experience

Years of investing experience (not including receiving interest on deposits): 16

I have purchased the following before:

Cash:

Treasury bills

Money market mutual funds

Fixed Income:

GICs

Bond mutual funds or segregated funds

Equity:

Common shares

Income trusts

Equity or balanced mutual funds or segregated funds

Insurance:

Term life insurance

Experience with investments outside Canada:

Equity in foreign companies

Risk

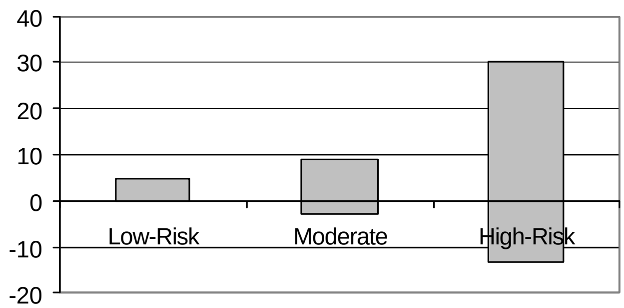
Minimum percentage of this account that I want invested with a low risk of loss of principal:	75%
Maximum percentage of this account that I want invested in a way that might expose my principal to a high level of risk:	10%
Percentage loss of principal at which I would like BigBank Securities to call me about reviewing this account:	10%
I am willing to accept a little short-term price volatility in order to try to get higher returns.	

I would like my investments to roughly fall into those categories as follows:

Low risk:	75%
Medium risk:	15%
High risk:	10%

I do not contemplate borrowing money in connection with my investments in this account (buying on margin or selling short).

The following chart shows the range of returns anticipated from a low, medium or high risk portfolio:



It is recognized that some representatives are capable of better eliciting an investor's level of risk through other means, such as a risk evaluation questionnaire or conversations with the investor. The representative may use alternatives to the questions in the Fair Dealing Document dealing with the level of risk. However, if the form asks the client to select percentages for different levels of risk, at least five levels must be shown.

Taxation

I do not have particular tax goals for this account (e.g., income splitting).

General

Other comments about how I prefer my money to be invested: None

Completeness

None of my responses are incomplete.

Initial Approach to Investing for the Account

Adviser's assessment of investor's tolerance for risk	Low
Desired rate of return (could be stated in terms of a range)	3-5% above inflation rate
Types of investments intended for initial inclusion in the account	Common shares, income trusts, bonds and treasury bills
Diversification goals	Higher risk investments to be in foreign securities
Any restrictions on investments	None
Initial asset allocation	To be determined
Treatment of investments switched into this account	Consult George in advance due to capital gains concerns.

This is the equivalent of the Investment Policy Statement provided by some firms. This section is important to helping establish an initial meeting of the minds between the investor and the representative concerning the manner in which an advised or managed-for-you account will be invested. This practice is already followed by many representatives in creating an investment policy statement.
Firms may modify the items in accordance with their methods for serving investors and investors' preferences so long as some form of investing framework is agreed.

Initials of adviser: ________________

Initials of investor: ________________

Receiving Annual Reports and Shareholder Meeting Materials

For securities for which I do not hold certificates registered in my name, I do not want to receive copies of annual reports and all other material sent to security holders.

It is proposed to substantially shorten the disclosure currently provided to investors concerning the delivery of material to non-registered shareholders by asking investors the essential questions about the receipt of materials without providing a description of the legal background.

My Responsibilities

This section alerts the investor to their own responsibilities with respect to the account.
Certain responsibilities would have to be stated. A firm could add others.
The contents of this section vary significantly among the three types of relationships.

- I will provide information to BigBank Securities with reasonable accuracy. I understand that the ability of BigBank Securities to help me reach my overall investment goals also depends on the completeness of the personal information I provide.
- I will update BigBank Securities promptly about any change in my financial needs or investment goals.
- If BigBank Securities sends me a communication asking for a response, I will respond as requested.

What BigBank Securities will do for me

This section seeks to avoid misunderstandings by communicating to the investor the responsibilities of the financial services provider and the limitations on those responsibilities.
Certain responsibilities would be required to be stated. An financial services provider could add others as desired.
The contents of this section vary significantly among the three types of relationships.

- Jane Jones will be my agent. She will act on my behalf in making investments for me. Her principal responsibility in helping me make investments must be to me. Both her and BigBank Securities will always deal with me fairly, carefully, honestly and in good faith.
- BigBank Securities will make investments on my behalf without consulting me in advance.
- BigBank Securities will send me summary statements about my account at least every three months. My statements will show what has happened in my account since my last statement. They will also give me information about the performance of my account, the overall risk level of my account, and the amount of fees and expenses I have paid to BigBank Securities or that has been paid to BigBank Securities on my behalf. At the end of each year, BigBank Securities will give me information about the total amount of fees and expenses I have paid during the year.
- BigBank Securities will review my account with me each quarter. When BigBank Securities does so, BigBank Securities will ask me about any changes in my investment goals.
- BigBank Securities will provide ongoing monitoring of my portfolio and rebalance when appropriate.
- BigBank Securities will respond promptly to any questions or complaints I may have.

Information BigBank Securities Will Give Me About Investing

BigBank Securities must offer me information sheets about investing in securities generally and particular types of investments. These sheets are designed to give a basic introduction to a subject and alert me to the risks and limitations of the investments. BigBank Securities strongly recommends that I read the sheets they give me on any subject with which I am unfamiliar. If there is anything I do not understand in one of the sheets, I can ask Jane Jones.

Whenever I consider making a new type of investment, BigBank Securities will have a sheet on it for me.

I have indicated below which information sheets I want mailed to me.

- ☑ Securities (General)
- ☑ Equities
- ☑ Bonds
- ☐ Mutual funds
- ☑ Income trusts
- ☐ Exchange traded funds
- ☐ Options
- ☐ Limited partnerships

This section allows the investor to choose which information sheets they want. The securities (general) information sheet could be made a compulsory disclosure item, at least for those who have not yet received it, due to its general applicability and the importance of some of its contents, such as the discussion about risk.

What To Do If I Have a Problem

If I have a problem with this account, I understand that I may first speak to Jane Jones and her immediate supervisor.

- If I am not satisfied, I understand that I should contact [BigBank Securities Compliance Dept. contact].
- If I am still not satisfied, I can contact [identify principal regulator or "Compliance Inc."]. I can also take my case to court or to arbitration.

Investors need to be given information and encouragement to raise complaints and concerns about their representatives with the Branch Manager or higher. Clients' reluctance to complain beyond the level of the representative can contribute to compliance problems going undetected until a crisis occurs.

In Part V of the Concept Paper we refer to the single service provider license and the notion of outsourcing compliance, which will be developed further in our second Concept Paper.

Finalise the Fair Deal

I and BigBank Securities have agreed to the contents of this Fair Dealing Document.

I received a copy of this Fair Dealing Document at the offices of BigBank Securities.

Account no.: 21345678

Date: October 1, 2003

The investor has the option of entering into the agreement right away, going back to make revisions, or first printing off and reading a hard copy.
The Fair Dealing Document would be signed by both the adviser and the client if a hard copy is prepared in a person-to-person setting.
The parties would agree to the Fair Dealing Document electronically if it is completed over the Internet.

____________________________ ________________

Signature of Client Date

____________________________ ________________

Signature of BigBank Representative Date

Appendix B

Sample Information Sheets

This Appendix includes sample investor information material on investing generally and on specific types of investments.

The general securities information sheet mainly includes general information about the taxation of investments, both within and outside an RRSP, and an introduction to the various types of risk. Due to its general applicability, it is proposed that advisers would be required to provide it to investors at the initial meeting stage, on or after entering into the Fair Dealing Document.

The information sheets on the various types of investments would include content on what the security is, how retail investors buy and sell the security, the nature of the market for the security, how retail investors compensate their service providers, and risk considerations relevant to the particular security.

Once comment is received on these information sheet templates, we will prepare sheets on other types of investments, including income trusts, exchange traded funds, hedge funds, wrap accounts, limited partnerships and options.

Sample Investment Information Sheet

The purpose of this information sheet is to help you make informed decisions about investing by converting cash you have saved into securities, i.e. investments which you expect will increase in value or generate a return over time. It covers a few general topics, such as RRSPs and taxation of your investments, risk and borrowing to invest. Before you invest in particular securities, we also will give you information sheets about investing in those types of securities. We have these information sheets available for you:

Equity
Bonds
Mutual funds
Income trusts
Exchange traded funds
Wrap accounts
Limited partnerships
Options

A Securities Information Sheet must be provided with the Fair Dealing Document on the opening of an account, when the purchase of securities is contemplated if not provided previously and whenever requested by the investor.

How Am I Taxed on Money I Put into an RRSP?

Putting your money into a registered retirement savings plan (RRSP) has two key advantages:

- It is deductible from your income in calculating your income tax. As a result, it lowers the amount of tax you are required to pay. The higher your marginal tax rate, the greater the benefit you will receive from an RRSP contribution.
- All amounts earned by investments in your RRSP are free of tax as long as they remain in your RRSP. This allows the full amount of any profits you earn to be reinvested in the hope of earning further profits on your profits. The younger you are, the greater the benefit you might receive from this benefit by having more years in which to compound any profits your earn. This benefit is also available for other non-taxable plans.

However, money you put into your RRSP does not remain tax-free forever. Eventually the government will require you to withdraw certain amounts from your RRSP or other taxable plans even if you do not need those amounts to pay your expenses. You will be required to pay tax on all amounts withdrawn from your RRSP or other non-taxable plan, whether or not voluntarily. You will be taxed based on the tax rate applied to your ordinary income at that time. You will not receive the benefit of any lower tax rates otherwise payable on dividends received from Canadian corporations or capital gains.

State any additional account holding and withdrawal fees incurred for an RRSP account.

In deciding whether to invest your money through an RRSP, you should also be aware of the following:

- You will not be able to deduct certain expenses relating to your investments in an RRSP.
- The government places some limitations on how you can invest the money in

your RRSP. You can incur significant penalties if you violate those limitations.

- You are not allowed to hold any currency other than Canadian dollars in an RRSP account. For example, if you receive proceeds in U.S. dollars on selling a stock, those proceeds will immediately be converted into Canadian dollars. If you then wish to buy another stock in U.S. dollars, the purchase amount must be converted back into U.S. dollars. The two conversion rates will not be the same, which generally will result in a loss based on the spread between our foreign exchange buy and sell rates.

Please let your adviser know if you would like more information about your RRSP contribution limits, the timing of your income tax deduction, limitations on investments in your RRSP, RRSP withdrawal requirements, and using an RRSP for family tax planning.

How Am I Taxed on Investments that I Hold Outside my RRSP?

Interest: Fully taxable.

Dividends paid by Canadian corporations: Fully taxable, but you receive a tax credit equivalent to 16 2/3% of the amount of the dividend.

Dividends paid by non-Canadian corporations: Fully taxable, but a tax credit could be available if tax was withheld on the amount of the dividend by a foreign government.

Capital gains: Taxable at a rate of 50% of the rate applied to your ordinary income. Capital losses are deductible from capital gains, but not from other income.

Mutual funds: Mutual funds distribute any income they earn at least annually. You are required to pay tax on income distributed to you. This includes capital gains earned by the mutual fund, even if you have not sold any part of your investment in the fund.

Please speak to your adviser or tax planner for information about your personal tax situation.

How Are My Investments Subject to Risk?

Your investments are subject to risk in two ways:

- Uncertainty over whether your investments will achieve the return you are targeting, including the risk of losing some of your principal. The various types of uncertainties that arise from investments are outlined under the next heading. One problem to keep in mind when creating investment targets and measuring the probability of missing those targets is that this is based on historical data and historical data could be unreliable in predicting the future.
- Uncertainty over the amount of money you will need in the future. For example, in trying to estimate how much money you will need for retirement, there is uncertainty over what items you will need to buy, future inflation rates, and when you will be retired. You do not know how long your funds for retirement need to last.

What Are the Types of Investment Risk?

Market risk: Market risk is the movement of securities prices up or down in response to changing conditions in the domestic or global economy or in the market itself. These changes can be unpredictable and beyond the investor's ability to forecast. Most investments are subject to the risk of a general fall in the market. For example, bonds generally go down in price when interest rates go up. For stocks, a change in general market sentiment or an unfavourable economic outlook can result in a general decline in prices. The price of a particular stock can fall even if there is no change in its own business prospects.

Individual security risk: A particular security carries its own level risk. This level of risk depends in part on the type of security. Short-term Canadian and U.S. government money market instruments are essentially risk-free, with the degree of risk increasing with longer-term government bonds, "investment grade" corporate bonds, and other corporate bonds. Stocks generally carry a higher level of risk than bonds, with some stocks carrying a higher risk level than other stocks. This is explained in greater detail in the bond and equity information sheets.

Portfolio risk: The risk of individual securities can be reduced by the creation of a well-diversified portfolio. A well-diversified portfolio reduces risk by including securities that tend to move in different directions. Diversification also reduces risk to a lesser extent even for securities that tend to move in the same direction by reducing the impact of an unexpected problem particular to one issuer.

You can diversify an equity portfolio by buying shares of companies in different business sectors or based in different countries. Further diversification might be achieved by adding bonds to a portfolio of equities or equities to a portfolio of bonds.

With smaller amounts of money, diversification can be achieved most easily by investing in a pooled investment, such as mutual funds or exchange traded funds. [*link to mutual fund information sheet for online version*]

A portfolio that starts out well-diversified can become much less so if certain securities significantly outperform the others, leading to a high concentration in the outperforming securities. Diversification could be restored by selling some of the securities that have risen and investing in others that do not tend to move in the same direction at the same time.

Foreign exchange and political risk: If your living expenses are mainly in Canadian dollars, investing in securities that are priced in a different currency entails a foreign exchange risk. In addition, some foreign investments may carry a political risk.

Reinvestment risk: Reinvestment risk occurs if you invest in shorter-term instruments and find that when the security matures and your principal is repaid, similar investments then carry a lower interest rate. Reinvestment risk also arises in buying longer-term bonds if you intend to reinvest the interest you receive periodically. At the time you receive an interest payment and have the opportunity to reinvest it, the interest rates available for reinvestment might have declined. The amount of your interest payments also might be too small to buy a similarly high-yielding investment.

Intermediary risk: Intermediary risk is the risk that you lose your investments because we become bankrupt. You are protected from intermediary risk with us up to one million Canadian dollars in total in your accounts because we are a member of CIPF, the Canadian Investor Protection Fund. [*Replace by reference to other investor protection funds as applicable*.]

How Can I Find out About the Risk Level of my Investments?

Before you confirm a purchase of a security, we will give you information about its level of risk. We will also give you information about how it affects the risk level of your overall investment portfolio.

Reports we send you about your portfolio will include information about its level of risk and diversification.

Can I Borrow Money From You to Invest?

We can lend you money to invest, up to certain limits that are imposed on us. This is profitable for us because the interest rate we will charge you on the loan is higher than the interest rate we will pay to other investors on their balances. It is called "margin lending."

Borrowing to invest increases the risk level of your investment:

- If you borrow money, so long as you can make interest payments, you can capture gains without having to accumulate a lump of cash out of your savings first. However, you are obliged to repay the debt. Thus, just as borrowing to invest allows your returns to be magnified, it also allows your losses to be magnified.
- Except in special circumstances such as a short-term loan to obtain cash for a contribution to your RRSP before the deadline, you will lose money on the amount you borrow if your return does not exceed the interest rate you pay on the loan.
- If you put up collateral in connection with a margin loan and the size of your investment portfolio falls below a certain level, you may be forced to sell some of your investments at an undesirable time after the market has fallen. This is described in greater detail in the next section. If we are unable to contact you when this happens, we may have to decide which of your investments to sell without consulting you.
- Investors who borrow money to invest are more likely to be forced to sell investments at an undesirable time when unexpected financial needs arise, such as losing their jobs.

What Happens if the Value of my Investment Portfolio Falls Below Your Required Level?

[*Plain English description of margin call consequences and procedures.]*

What if I Have a Defined Benefit Pension Plan?

A defined benefit pension plan has the key advantage of reducing your future level of risk. This is particularly true if the benefits are adjusted for inflation. You should keep this in mind when considering whether you might be able to achieve better results by investing the funds now available to you on your own.

Sample Equity Information Sheet

An Equity Information Sheet must be provided with the Fair Dealing Document on the opening of an account, when the purchase of equity is contemplated if not provided previously, or whenever the information in it is requested by the investor. The information sheet does not need to be provided to an investor who does not want it or who does not then intend to buy equity.
An Equity Information Sheet should also be provided to the investor when the investor has questions about the contents of the information sheet and has misplaced it.
Information equivalent to that contained in the following sample statement must be provided.

What is Equity?

Businesses, usually organized as corporations, can raise money by selling ownership interests in the business. The ownership interests entitle you as the purchaser to share proportionally in any profits of the business and any increase in the value of the business over time. They also subject you as the owner to the risk of loss of your investment if the business is not profitable or if the business suffers a reversal of fortune. This uncertainty as to gain or loss is the key feature of an equity investment.

The management of a business in which you invest may decide to use its profits for business purposes, pay some of them out to you and other investors as dividends, or repurchase a portion of the ownership interests. If a business is sold off in its entirety, or liquidated (which rarely happens), you would have the right to receive your portion of the liquidated assets once all creditors and other holders of prior claims have been paid.

As a shareholder of a corporation, you would also have certain other rights. These include the right to receive financial and other information and the right to vote at shareholder meetings.

Equity ownership in corporations usually is in the form of common shares. Sometimes in Canada they are in the form of subordinated voting shares, Class A shares or Class B shares, which are similar to common shares except that they have reduced voting rights. If listed on The Toronto Stock Exchange, these shares have a designation such as ".A" or ".B" at the end of the symbol for the stock. Ownership interests in businesses based outside North America might be in the form of American Depositary Receipts, which allows investors to buy and sell the ownership interests and receive dividends on them in U.S. dollars.

Equity investments also could be in other types of legal entities, such as income trusts and limited partnerships. These vehicles pool corporate equity instruments or give you indirect tax sheltered rights in cash flow from a corporation's business activities. For more information on income trusts or limited partnerships, ask your adviser for the Information Sheet on income trusts or limited partnerships

How is the Price of an Equity Investment Determined?

The price of an equity investment is set by the collective view of the investing marketplace. This view is affected by many factors, which could include the following:

- Past profitability and expectations as to future profitability.
- Past dividend payments and expectations as to future dividend payments.
- The amount of cash generated by the business in the past and expectations as to the ability to generate cash in the future.

- The value of the assets.
- Perceptions as to the desirability of the investment to other investors, such as whether the price has been moving up or down.
- Expectations as to changes in the future supply of the shares, such as whether a large number of new shares might be issued in the near future or a large shareholder might sell its shares.
- Factors that might affect the general desirability of equity investments in relation to other investments, such as changes in interest rates or changes in general views as to the overall movement of the equity markets.
- The investment's liquidity or how readily investors are able to dispose of the investment when desired.

Factors that could rapidly affect the price of an equity investment include:

- An announcement about how the business has been doing in the past, including the release of quarterly financial statements.
- An announcement about a new development in the business or the future prospects of the business.
- News about the economy or national or international developments.
- News about the business conditions of competitors or customers.

How Is Equity Sold?

At times equity is sold at a set price by the business itself to raise funds or by a large shareholder. If there is not yet a public market in the equity, the sale is known as an initial public offering or IPO.

More commonly equity is sold by existing shareholders like you, usually on a stock exchange or other marketplace, to the highest bidder.

The following section is subject to revision depending on the alternatives used by the service provider. The following section is not required for Managed-For-You investors.

How Do I Place an Order to Buy or Sell Equity?

If you wish to buy or sell equity, ordinarily we will place an order on your behalf to buy (bid) or sell (ask) a specified amount. You may choose whether to place your order as a market order or a limit order. If you place a bid as a market order, you are stating that you wish to buy the equity at the lowest price at which someone is then willing to sell. In the case of an "ask", you are stating that you wish to sell the equity at the highest price that someone is then willing to pay.

A market order has the advantage of assuring you of being able to buy or sell so long as there are sellers or buyers on the other side. However, for equity that trades less frequently or for which there is a larger "spread" between the bid and ask prices, a market order could result in your price being significantly worse than the price you last saw quoted.

Particular caution should be used in placing market orders in circumstances where the trading price could be unpredictable. Examples are the start of trading upon an IPO or the resumption of trading immediately after a very significant news release.

If your order is a limit order, you are stating that you would buy or sell the equity only if someone accepts your stated price. A limit order allows you to wait for a better price than the price then quoted. The disadvantage of a limit order is that it might not be filled.

What Happens Once my Order Is Placed?

Your order could be filled in the following ways:

- Sent to a stock exchange or other market for matching.
- Matched with an order placed by another of our clients
- Sold to you from our holdings or bought by us.

How Much Do I Pay to You for Buying and Selling Equity?

Ordinarily you would pay an amount of commission as shown in our commission schedule. Included in the commission is a fee we pay to an exchange or other market on which the trade occurs. If we sell you equity from our own holdings or we buy your equity, you would not pay us a commission. Instead we would make a profit, or loss, based on our own purchase or sale price.

In the case of a public offering by a business or selling shareholder, you do not pay us any commission, but we will be paid a commission by the company or a selling shareholder. This commission would be higher than the commission we receive from you for a trade on an exchange. You also do not pay any commission if you accept a take-over bid.

How Do I Know What is Happening to My Investment?

[*Financial Services Provider to insert*]

See Appendix E: Ongoing Reporting and Monitoring

How Could I Find Out the Level of Risk of Equity?

An investment in equity entails a risk of loss due to overall changes in the market and a risk of loss unique to a particular business. Market risk is the movement of securities prices up or down in response to changing conditions in the domestic or global economy or in the market itself. These changes can be unpredictable and beyond the investor's ability to forecast.

The price of a particular equity investment also could go up or down as a result of developments in the underlying business or other changes relating to the particular investment. This element of risk can be reduced by the creation of a well-diversified portfolio. A well-diversified equity portfolio reduces risk by including equities that tend to move in different directions. The traditional rule of thumb is that at least 10-15 carefully chosen equities are required for a diversified portfolio. Recent research suggests that higher volatility in the markets points to 30 as the minimum number. Alternatively, diversification can be achieved by investing in a collective investment schemes, such as mutual funds or indices.

Diversification can be increased by investing in other types of securities, such as bonds.

A portfolio that starts out well-diversified can become much less so if certain equities significantly outperform the others, leading to a high concentration in the outperforming equities. Diversification could be restored by selling some of the equities that have risen and investing in others that do not tend to move in the same direction at the same time.

The risk level of a particular equity usually is determined by subjectively assessing the future prospects of the business or by measuring the degree to which the equity's price has fluctuated in the past compared to the market as a whole (known as its volatility). A risk determination based on past volatility assumes the business has remained sufficiently constant that future volatility would be expected to be similar. If you intend to hold an equity security over the longer term, the degree of volatility is likely to be of less importance.

A more forward looking measure of volatility is available for some equity securities by looking at the pricing of options on the securities. The cost of buying a put on the equity for a certain date is added to the cost of buying a call on that equity for the same date. The higher the total cost in relation to the price of the equity, the more volatile the market views that equity over the option period.

When you buy equity through us, we will tell you our assessment of its level of risk.

Financial services provider to state the method used and also to explain how to use the method of assessment. The example that follows is for betas.

The beta is calculated relative to a broad market index. The S&P TSX index is used for Canadian stocks. A beta of 1 indicates a level of volatility equal to the shares in the index. A beta of less than 0.7 shows significantly less volatility than the index. A beta higher than 1 shows volatility higher than the index.

In recommending equity to you, we will also be able to tell you how it affects your portfolio's diversification.

Can I Invest in Equity Without Owning the Equity Itself?

You can have an interest in equity by owning securities such as rights, warrants, options and convertible bonds. The first three are forms of derivatives, specialized securities which allow you to place bets on the value of the underlying equity without purchasing it directly or limit your risk if you own the underlying equity. Convertible bonds allow you to earn interest, but with the opportunity for a greater upside if the equity appreciates. We can give you information should you be interested in any of them.

Sample Bond Information Sheet

A Bond Information Sheet must be provided as part of the Fair Dealing Document on the opening of an account, when the purchase of bonds is contemplated if not provided previously, or whenever requested by the investor. The information sheet does not need to be provided to an investor who does not want it or who does not then intend to buy bonds.
A Bond Information Sheet should also be provided to the investor when the investor has questions about the contents of the information sheet and has misplaced it.
The Bond Information Sheet must be revised to reflect additional information of the same nature relating to bonds as transacted by the firm, or future changes in the manner in which bonds are transacted.
Information equivalent to that contained in the following sample statement must be provided.

What Are Bonds?

A bond is a long-term commitment by a borrower to repay a loan. The borrower can be a government, a corporation or another entity. In its basic form, a bond requires a borrower to pay a specified annual interest rate and to repay the principal after a specified number of years. However, bonds can have a wide range of other attributes. For example, some corporate bonds are convertible at the investor's option into another security such as common stock. Investors in other bonds could be forced to sell their bonds back to the issuer at the issuer's option.

How Do I Know What a Bond is Worth?

The price of a bond depends on:

- The length of time until the principal must be repaid (the bond's time to maturity)
- The interest rate of the bond (or coupon rate). The payment you receive each year on a bond based on what you actually pay for it is known as its yield.
- The anticipated ability of the borrower to make interest payments and repay the principal at the required time (the borrower's creditworthiness).
- How readily the bond can be resold (the bond's liquidity) and the status of the bond as a "benchmark".
- Any special attributes of the bond.
- Any special tax features of the bond.

How Do I Buy or Sell a Bond from You?

[*Financial Services Provider to insert*].

As an alternative to buying or selling bonds directly from us, you could invest in bonds collectively with others, such as through a bond mutual fund.

How Much Do I Pay You for Buying and Selling Bonds?

Should you wish to buy or sell a bond, we will quote you the prices at which we would be willing to sell you the bond or buy it from you. The difference between the two prices, known as the spread, will give you an indication of our profit on the bond. We will not charge you a fixed commission or other fee.

See "Transparency of compensation received – Bonds" in Part IV of the Concept Paper.

Our actual profit (or loss) on selling you a bond will differ somewhat from the spread, depending on how we bought the bond and changes in the bond market since we bought it to sell to our clients.

How Would I Find Out About the Risk of a Bond?

In buying a bond, you primarily take on three types of risk: credit risk, market risk and reinvestment risk. The purchase of bonds with special attributes could entail additional risk factors. For example, the risk of bonds convertible into common stock will depend in part on the risk of the common stock.

The credit risk is the risk that the borrower will be unable to pay you the interest on the bond and repay the principal when due. Even if the borrower is making all payments when due, if its creditworthiness falls, the price of its bonds generally will go down.

The credit risk of a bond is assessed by its assignment of a credit rating by a rating agency. Federal government bonds carry the highest rating (lowest risk), in a credit spectrum that moves from investment grade provincial and corporate bonds, to high-yield bonds to unrated debt. The cumulative default rates over one, three and five years for government and corporate borrowers is shown in the table below:

Default Rates for Various Ratings (%)

Rating	*One-Year*		*Three-Year*		*Five-Year*	
	Government	Corporate	Government	Corporate	Government	Corporate
AAA	0.00	0.00	0.00	0.08	0.00	0.20
AA	0.00	0.02	0.00	0.09	0.00	0.23
A	0.00	0.04	0.00	0.18	0.00	0.47
BBB	0.00	0.20	1.69	0.76	2.94	1.73
BB	2.00	0.90	1.49	4.91	0.00	8.81
B	2.44	5.02	5.00	14.77	0.00	19.89
CCC	0.00	20.32	0.00	30.88	0.00	37.50

Source: Standard & Poors 2001

The table shows that ratings appear to be a fairly useful guide to the credit risk for corporate bonds, but the connection seems very loose between the ratings of government bonds and default rates. Rating agencies have been criticized for downgrading bonds after the increased risk is already built into the price of the bond. The change in rating may have taken place before bond payments were in default, but not before bondholders suffered significant losses.

The credit rating gives an indication of the degree of default risk. The yield obtained from the bond is generally in line with that risk. A difference in yields for bonds with the same rating and term is an indication of changing conditions for one of the borrowers.

The overall level of risk of a bond portfolio containing higher risk bonds can be reduced by including bonds issued by different borrowers in different economic sectors.

When you buy a bond from us, we will tell you the bond's credit rating and outlook.

What Is Meant by the Market Risk of a Bond?

The market risk of a bond is the risk that its price will fall in response to changing conditions in the domestic or global economy or the market itself. For bonds the key market risk is an increase in interest rates. A bond paying a fixed rate of interest will be worth less if a higher interest rate becomes available from newly issued bonds. Thus, if you were to sell the bond, you would receive a lower price for it.

If you were to continue to hold a bond until maturity, you would continue to receive its fixed rate of interest if the borrower doesn't default. However, you would forego the opportunity to use your funds to receive a higher interest rate on other bonds.

The longer a bond's remaining term to maturity, the greater the likelihood of changing conditions and the greater its market risk.

Should I Be Concerned About Reinvestment Risk if I Buy Long-Term Bonds?

In buying bonds, you will incur reinvestment risk both when the bond matures and when you receive interest through payment of the coupons, usually annually or semi-annually.

When a bond matures, you might not be able to reinvest the principal at the same rate of interest. During periods of historically high rates, an investor will usually be better off choosing a longer term (10 years or more). Shorter terms or money market instruments, such as treasury bills or corporate paper, could be preferable if interest rates are lower than normal.

Even for longer term bonds, you will incur reinvestment risk if you intend to reinvest your interest payments. When you have the opportunity to reinvest an interest payment, the interest rates available on similar bonds might have fallen. The amount of your interest payments also might be too small to buy a similarly high-yielding investment. The quoted yield to maturity on a bond assumes the coupons paid are reinvested at the same rate, but that generally is not the case.

What Information Will You Give Me When I Buy or Sell a Bond?

When you buy or sell a bond, we will tell you the following about the bond:

- The name of the borrower.
- The price at which we would sell you the bond or buy the bond from you.
- Its face amount, which is the amount you would receive on redemption.
- Its maturity date.
- Its stated interest rate, or coupon rate.
- Its yield, the effective interest rate you would earn at its purchase price by holding the bond until maturity if all interest payments are invested at the same rate.
- Its credit rating, including the outlook provided by the credit agency.

Yield is a key item to consider in comparing two bonds. Yield takes into account the price, the face amount and the coupon rate. In comparing the risk level of two bonds, the credit ratings and maturity dates are key items to consider.

If you buy a bond at a price below its face value and hold it to maturity, the profit over your purchase cost is taxed at maturity as a capital gain. This is half the rate at which your interest income is taxed. Buying a bond at a price above its face value will result in a capital loss on maturity.

How Do I Know What is Happening to My Investment?

[*Financial Services Provider to insert*]

Sample Mutual Fund Information Sheet

(with third party sales compensation)

A Mutual Fund Information Sheet must be provided as part of the Fair Dealing Document on the opening of an account, when the purchase of mutual funds is contemplated if not provided previously, or whenever requested by the investor. The information sheet does not need to be provided to an investor who does not want it or who does not then intend to buy mutual funds. A Mutual Fund Information sheet should also be provided to the investor when the investor has questions about the contents of the information sheet and has misplaced it.
Except for Self-Managed accounts, the representative is required to ascertain by questions whether the client understands the information sheet no later than the time the client first invests in mutual funds.
The Mutual Fund Information Sheet must contain plain language explanations about mutual funds, the manner in which service providers are compensated, and, for taxable accounts, the taxation of mutual fund investments.
Information equivalent to that contained in the following sample statement must be provided.

What is the Purpose of a Mutual Fund?

Companies that create mutual funds are in the business of managing investments for investors who want to have their money managed by an expert. Mutual funds allow the money provided by a large number of investors to be managed in a way that is convenient to administer. The more assets a fund company attracts to its mutual funds, the greater its revenues.

In return for a percentage of the funds you invest, the fund management company provides a means for you to pool your money with that of other investors to pay an investment expert (the portfolio manager) to use its discretion to invest the money with the intention of increasing its value over time.

How Do I Choose a Mutual Fund?

Mutual fund companies offer a variety of mutual funds that compete for your investment dollars. You should consider carefully what they are offering before making a choice. We can sell you mutual funds from [various mutual fund companies]/[our own family of mutual funds]/[our own family of mutual funds as well as other mutual funds].

Different funds invest in different types and mixes of securities, are managed by experts with varying views using different strategies, and have different risk profiles. Mutual funds also vary in the fees they charge for their management services and in the amount they pay to us. Your adviser should explain this to you for any funds you are thinking of purchasing.

Some mutual funds hold a diverse selection of securities. Examples include balanced funds holding both bonds and stocks, many Canadian and international equity funds, and asset allocation funds. For some investors one or two of these funds could be sufficient. Other investors also prefer to own more specialized mutual funds in addition to their core funds. You should discuss with your adviser how any mutual fund you are thinking of buying fits with your other investments.

Your adviser will know which mutual funds are considered Canadian property for RRSP and other tax-advantaged accounts. In some cases fund companies have created versions of their foreign funds that satisfy the Canadian property requirements. These RRSP-eligible funds incur some costs in addition to the costs of the funds on which they are based.

What Happens When I Invest in a Mutual Fund?

As a result of pooling your money with that of others in a mutual fund, you will share in the profits or losses resulting from the fund's investments in proportion to the amount of your investment. You will also share in the fund's expenses, including amounts it pays to the expert portfolio manager and to sales agents or advisers such as us. The return from your investment will be affected by the amount of the fund's expenses.

At times, most commonly near the end of the year, mutual funds distribute earnings to their investors for tax purposes. The distribution will lower the value remaining in each of your units or shares. You can arrange with us to have your distributions reinvested, commission-free. This will increase the number of units or shares you own and leave the total amount of your investment in the fund the same as it was before the distribution.

How Do I Know What Is Happening to my Investment?

The mutual fund company determines the value of the fund's assets at specified times, usually at the end of each day. This amount is called the fund's net asset value or NAV. The net asset value divided by the total number of units (or shares) at the time is known as the net asset value or NAV per unit (or share). The NAV per unit (or share) is available from various sources, including daily newspapers and the Internet.

The reports we send you will show the NAV per unit (or share) for each of your funds on the date of the report, the number of units or shares you own, and their total value. The reports will also show the performance of your own investments. Information on the performance of each of your individual mutual funds also is available in newspapers and on the Internet.

The fund management company provides periodic snapshots of its investments and other information. This information is available from us from the fund management company or on the Internet.

Please let us know if you would like us to give you some specific sources you can use for updated information on your mutual funds.

What Costs Do I Pay as an Investor in a Mutual Fund?

In addition to any commission that you pay directly, the costs you pay indirectly as an investor in a mutual fund are the management fee, the dealer fee, the fund's general expenses, and the fund's trading costs.

The management fee is paid to the fund management company for its services, which include making the investment decisions. The dealer fee is paid to us as a commission and we remit a portion of it to your adviser. These fees vary from fund to fund. We will tell you the amounts of these fees before you invest and your adviser is available to explain them to you

The fund's general expenses usually include costs such as legal, accounting and printing costs and government filing fees. The trading costs include brokerage commissions paid to brokers for buying and selling the fund's securities and related services.

What Is Meant by the Expense Ratio of a Mutual Fund?

A mutual fund's expense ratio is the percentage of assets it pays during the year for the management fee, dealer fee and expenses. Brokerage commissions are not included in the expense ratio, but are instead added to the cost of buying securities or deducted from the proceeds of any sale.

What Commissions Am I Required to Pay Directly?

Whether and when you would be required to pay a direct commission depends on the type of mutual fund in which you invest.

Front-end load funds: A commission is deducted from the money you send to the mutual fund.

Back-end load funds: Depending on how long you own the fund, a commission might be deducted when you withdraw money. This commission is often called a deferred sales charge (DSC).

Optional load funds: The investor has a choice between paying a front-end load or a back-end load.

Funds with both loads: A number of mutual funds have both front-end loads and back-end loads.

No-load funds: No commission is payable at the time of purchase or withdrawal. We sell no-load funds.

These direct commissions are in addition to any dealer fees we would receive from you indirectly in the form of payments out of the assets of the fund. You might also be required to pay an additional charge if you sell within a very short period of time.

We will tell you about the types and amounts of commissions payable for a fund before you invest.

You can check the financial impact of any expense ratio and front-end or back-end load at this website: •

What Are the Advantages and Disadvantages of a Front-End Load?

A front-end load reduces the amount of your investment. This has the significant disadvantage of reducing the money on which you hope to earn a profit for the entire duration of your investment. However, a front-end load has the advantage of being set by us. It [usually] is a [much] lower percentage than the back-end load you would pay if you withdrew your money soon after making your investment. Our charge for mutual funds bought with a front-end load is [negotiable]/[X%]/[$X].]

What Are the Advantages and Disadvantages of a Back-End Load?

A back-end load begins at a fairly high percentage in the first year you own a mutual fund. It gradually becomes smaller from year to year, until it eventually reaches zero. In addition, you usually are allowed to withdraw a small portion of your money each year without paying any commission. You also do not have to pay commissions in withdrawing amounts that you automatically reinvested following distributions.

Buying a fund with a back-end load has the advantage of allowing you to avoid paying a direct commission if you continue to hold your investment for a specified number of years. However, you would have to pay the back-end load if you withdraw your money earlier, whatever your reason, such as needing the money for another purpose, dissatisfaction with the fund, or a change in the portfolio manager. It is likely that withdrawing your money in the early years will result in a larger amount being paid as commission if the purchase is made with a back-end load than with a front-end load.

Indicate if a rebate to the investor could be available on the initial commission.

The amount of the back-end load is set by the mutual fund. It is not negotiable, although for some funds there are options for choosing a payment schedule. The back-end load is paid directly to the fund management company. However, if you buy a fund with a back-end load, the fund management company will pay us a set commission at the time of your investment. The fund company would recoup the cost of this commission out of its management fee

For some mutual funds, the percentage paid as a back-end load is based on the amount you invest initially. For others it is based on the amount you receive. If the value of your investment increases over time, for any percentage back-end load the amount you pay will be lower if it is based on the amount you invested.

Certain back-end load funds are invested in the same manner as equivalent front-end load funds, but paying a different management fee or dealer fee. In recommending one of these back-end load funds, your adviser will inform you about the equivalent front-end load fund to help you make an informed decision about which is more suitable for you.

How Will my Mutual Fund Investment Be Taxed?

If you withdraw money from a mutual fund in a taxable account (i.e. not an RRSP or RESP), you will be taxed based on your capital gain or capital loss. In addition, you are required to pay tax on any amount distributed to you by a mutual fund as a capital gain, dividend or interest, even if your own investment has gone down.

Could a Transfer from one Mutual Fund to Another Result in Extra Costs?

The consequences of transferring your assets from one fund to another depends on whether the original fund and the new fund are managed by the same company (*i.e.*, whether they are in the same "fund family").

If the transfer is between funds in the same fund family, the clock on the back-end load will continue to run and you will not have to pay any additional commission. [However, we will charge you a fee for making the switch [of $X][of X%][, which is negotiable].]

If the transfer is between funds in different families, you could incur additional costs. Transferring from the original fund could require you to pay a back-end load. Transferring into the new fund could require you to pay a front-end load. The transfer also would cause the clock on any back-end load to start to run all over again.

In either case, the transfer could change the management fee you pay indirectly each year for the investment of your money. It could also change the dealer fee we receive from the mutual fund.

If your funds are held in a taxable account, the transfer will result in a capital gain or capital loss.

How Could I Find Out the Level of Risk of a Mutual Fund?

The level of risk of a mutual fund depends on the types of investments made by the fund and the extent to which those investments are diversified. A mutual fund containing only equity securities in a single industry sector generally is higher risk. A bond mutual fund generally is lower risk than an equity mutual fund. The number of mutual funds that should be held in a diversified portfolio will depend on the diversification of the individual mutual funds and the extent to which the various mutual funds move in the same direction or in different directions.

More information about the nature of the risk in an equity mutual fund is contained in our Equity Information Sheet. More information about the nature of the risk in a bond mutual fund is contained in our Bond Information Sheet.

Financial services provider to state the method used and also to explain how to use the assessment. The example that follows is for betas.

When you buy a mutual fund through us, we will tell you our assessment of its level of risk. The beta is calculated relative to a broad market index. For mutual funds the index used will be based on the types of investments contained in the fund. A beta of 1 indicates a level of volatility equal to the index. A beta of less than 0.7 shows significantly less volatility than the index. A beta higher than 1 shows volatility higher than the index.

In recommending a mutual fund to you, we will also be able to tell you how it affects your portfolio's diversification.

Sample Mutual Fund Information Sheet

(no third party sales compensation)

A Mutual Fund Information Sheet must be provided as part of the Fair Dealing Document on the opening of an account, when the purchase of mutual funds is contemplated if not provided previously, or whenever requested by the investor. The information sheet does not need to be provided to an investor who does not want it or who does not then intend to buy mutual funds.
A Mutual Fund Information Sheet should also be provided to the investor when the investor has questions about the contents of the information sheet and has misplaced it.
Except for Self-Managed accounts, the representative is required to ascertain by questions whether the client understands the information sheet no later than the time the client first invests in mutual funds.
The Mutual Fund Information Sheet must contain plain language explanations about mutual funds, the manner in which service providers are compensated, and, for taxable accounts, the taxation of mutual fund investments.
Information equivalent to that contained in the following sample statement must be provided.

What is the Purpose of a Mutual Fund?

Companies that create mutual funds are in the business of managing investments for investors who want to have their money managed by an expert. Mutual funds allow the money provided by a large number of investors to be managed in a way that is convenient to administer. The more assets a fund company attracts to its mutual funds, the greater its revenues.

In return for a percentage of the funds you invest, the fund management company provides a means for you to pool your money with that of other investors to pay an investment expert (the portfolio manager) to use its discretion to invest the money with the intention of increasing its value over time.

How Do I Choose a Mutual Fund?

Mutual fund companies offer a variety of mutual funds that compete for your investment dollars. You should consider carefully what they are offering before making a choice. We can sell you mutual funds from [various mutual fund companies]/[our own family of mutual funds]/[our own family of mutual funds as well as other mutual funds].

Different funds invest in different types and mixes of securities, are managed by experts with varying views using different strategies, and have different risk profiles. Mutual funds also vary in the fees they charge for their management services and in the amount they pay to us.

Your adviser should explain this to you for any funds you are thinking of purchasing.

Some mutual funds hold a diverse selection of securities. Examples include balanced funds holding both bonds and stocks, many Canadian and international equity funds, and asset allocation funds. For some investors one or two of these funds could be sufficient. Other investors also prefer to own more specialized mutual funds in addition to their core funds. You should discuss with your adviser how any mutual fund you are thinking of buying fits with your other investments.

Your adviser will know which mutual funds are considered Canadian property for RRSP and other tax-advantaged accounts. In some cases fund companies have created versions of their foreign funds that satisfy the Canadian property requirements. These RRSP-eligible funds incur some costs in addition to the costs of the funds on which they are based.

What Happens When I Invest in a Mutual Fund?

As a result of pooling your money with that of others in a mutual fund, you will share in the profits or losses resulting from the fund's investments in proportion to the amount of your investment. You will also share in the fund's expenses, including amounts it pays to the expert portfolio manager. The return from your investment will be affected by the amount of the fund's expenses.

At times, most commonly near the end of the year, mutual funds distribute earnings to their investors for tax purposes. The distribution will lower the value remaining in each of your units or shares. You can arrange with us to have your distributions reinvested, commission-free. This will increase the number of units or shares you own and leave the total amount of your investment in the fund the same as it was before the distribution.

How Do I Know What Is Happening to my Investment?

The mutual fund company determines the value of the fund's assets at specified times, usually at the end of each day. This amount is called the fund's net asset value or NAV. The net asset value divided by the total number of units (or shares) at the time is known as the net asset value or NAV per unit (or share). The NAV per unit (or share) is available from various sources, including daily newspapers and the Internet.

The reports we send you will show the NAV per unit (or share) for each of your funds on the date of the report, the number of units or shares you own, and their total value. The reports will also show the performance of your own investments. Information on the performance of each of your individual mutual funds also is available in newspapers and on the Internet.

The fund management company provides periodic snapshots of its investments and other information. This information is available from us from the fund management company or on the Internet.

Please let us know if you would like us to give you some specific sources you can use for updated information on your mutual funds.

What Costs Do I Pay as an Investor in a Mutual Fund?

In addition to any commission that you pay directly, the costs you pay indirectly as an investor in a mutual fund are the management fee, the fund's general expenses, and the fund's trading costs.

The management fee is paid to the fund management company for its services, which include making the investment decisions. This fee varies from fund to fund. We will tell you its amount before you invest and your adviser is available to explain them to you.

The fund's general expenses usually include costs such as legal, accounting and printing costs and government filing fees. The trading costs include brokerage commissions paid to brokers for buying and selling the fund's securities and related services.

What Is Meant by the Expense Ratio of a Mutual Fund?

A mutual fund's expense ratio is the percentage of assets it pays during the year for the management fee, dealer fee and expenses. Brokerage commissions are not included in the expense ratio, but are instead added to the cost of buying securities or deducted from the proceeds of any sale.

What Commissions or Fees Am I Required to Pay Directly to You?

Set out any commissions or fees payable to the dealer. If there are various payment options available, describe the advantages and disadvantages of each.

[The amounts of these commissions and fees are set out in our fee schedule.]

You can check the financial impact of any expense ratio and your commission payments at this website:

- [*company to insert*]

How Will my Mutual Fund Investment Be Taxed?

If you withdraw money from a mutual fund in a taxable account (i.e. not in an RRSP or RESP), you will be taxed based on your capital gain or capital loss. In addition, you are required to pay tax on any amount distributed to you by a mutual fund as a capital gain, dividend or interest, even if your own investment has gone down.

How Could I Find Out the Level of Risk of a Mutual Fund?

The level of risk of a mutual fund depends on the types of investments made by the fund and the extent to which those investments are diversified. A mutual fund containing only equity securities in a single industry sector generally is higher risk. A bond mutual fund generally is lower risk than an equity mutual fund. The number of mutual funds that should be held in a diversified portfolio will depend on the diversification of the individual mutual funds and the extent to which the various mutual funds move in the same direction or in different directions.

More information about the nature of the risk in an equity mutual fund is contained in our Equity Information Sheet. More information about the nature of the risk in a bond mutual fund is contained in our Bond Information Sheet.

Financial service provider to state the method used and also to explain how to use the assessment. The example that follows is for betas.

When you buy a mutual fund through us, we will tell you our assessment of its level of risk. The beta is calculated relative to a broad market index. For mutual funds the index used will be based on the types of investments contained in the fund. A beta of 1 indicates a level of volatility equal to the index. A beta of less than 0.7 shows significantly less volatility than the index. A beta higher than 1 shows volatility higher than the index.

In recommending a mutual fund to you, we will also be able to tell you how it affects your portfolio's diversification.

Appendix C

Transaction Information Templates for Financial Services Providers

This Appendix includes templates for the transaction summaries and confirmations required by the Fair Dealing Model. As with the Information Sheets we have included templates for bonds, equity and mutual funds. As with the Information Sheets, other summaries are planned for income trusts, exchange-traded funds, wrap accounts, limited partnerships, hedge funds and options.

Transaction Summary Templates

These templates list the transaction information which should be provided at point of sale. For online trades, the investor can be given the option of placing the order without any disclosure appearing beforehand.

Bonds

Bond Summary Template

Price at which the bond would be sold and bought:

Name of borrower:

Face amount:

Maturity date:

Coupon rate:

Yield:

Any special attributes (*e.g.*, conversion rights, guarantee features):

Credit rating and outlook:

Reason for recommendation *[Must be documented if point of sale disclosure is not in writing]*:

Any interests, associations or relationships that influenced the recommendation:

Equity

<u>Equity Summary Template</u>

Identification of class of equity:

Number of shares:

Price per share:

Indicated cost of shares or proceeds of sale *[Online trading only]:*

Commission or other transaction costs:

Total cost or net proceeds *[Online trading only]:*

Risk level:

Reason for recommendation *[Must be documented if point of sale disclosure is not in writing]*:

Any interests, associations or relationships that influenced the recommendation:

Mutual Funds

This disclosure would be a substitute for a prospectus at point of sale for the mutual fund recommended or purchased.

If the investor is given a written recommendation, the point of sale disclosure must be provided in writing at the time of the recommendation. Otherwise the point of sale disclosure must be provided before the investor confirms the order.

The disclosure assumes purchases of funds, except as otherwise noted.

Mutual Fund Summary Template

Name of fund:

Portfolio manager of fund:

Types of securities in which the fund invests (unless obvious from the name of the fund) and, if disclosed by the fund or otherwise known, the fund's investment strategy to the extent material to an investment decision:

Dollar amount to be invested:

Dealer fee percentage payable to the firm (if not reimbursed to the investor):

Most recent expense ratio:

- Replace by the management fee plus dealer fee if the fund has not yet stated its expense ratio (stating that this amount does not include expenses)
- Investor to be informed if the management fee or dealer fee has been increased or there is a subsequent change in the determination of the expense ratio
- Also disclose the amount of any performance fee
- Include both if there are different expense ratios for funds purchased with front-end loads and back-end loads

If front-end load, percentage of front-end load or that it is negotiable:

If back-end load, the percentage of the back-end load if sold immediately, whether the percentage is based on the purchase price or the proceeds, the number of years for the back-end load to reach zero, and the commission payable to the selling agent at the time of the purchase:

If the fund is sold only with a back-end load and there is another fund sold with a front-end load that is equivalent except for differences in the management fee, dealer fee or expense ratio, the above disclosure about fees and costs must be provided in writing for both funds in order for the investor to be able to compare the two:

In the case of a switch, the most recent expense ratio (modified as indicated above) and dealer fee for each mutual fund being redeemed:

In the case of a redemption, the percentage back-end load then payable and the next date on which the back-end load is reduced:

Any other charges and to whom paid:

If the adviser has a financial interest in the manager of the fund, a statement to that effect and the approximate dollar amount of the adviser's interest in the manager and its affiliates:

If the adviser's firm is the manager or an affiliate of the manager of the fund, a statement to that effect and whether the adviser receives a higher percentage of the commission than in the case of funds managed by non-affiliated firms:

In the case of a recommendation for a switch, the potential benefits that may be lost, and any other significant consequences of the switch. This would include the effect on redemption schedules applicable to the investor:

The risk level of the fund as assessed by the selling agent or based on published information such as beta figures:

Reason for recommendation *[Must be documented if point of sale disclosure is not in writing]*:

Any interests, associations or relationships that influenced the recommendation:

For each mutual fund or in aggregate, assuming there is no change in the value of the investment (this assumption being stated), unless no recommendation is made:

[For online self-managed trades, the dealer fee and expense ratio disclosure does not have to appear automatically, so long as it is accessible to the investor by clicking on a link.]

> The amount payable in respect of the expense ratio each year: *[If this is an aggregate amount, a separate aggregate amount of fees for funds for which the expense ratio is not yet known]*
>
> The amount payable to the firm as a dealer fee in each year (if not reimbursed to the investor):
>
> The amount payable as a front-end load:
>
> The amount payable as a back-end load if sold immediately and the amount of commission payable to the selling agent:

Confirmations

Confirmations Template

Date of trade:

Settlement date, if applicable:

For each security:

Whether purchase or sale:

Identification of security:

Quantity:

Price:

Amount paid by the investor or amount of proceeds:

Amount of any commission, spread, front-end load, redemption fee or other charge:

Net dollar amount of securities purchased or net proceeds:

[Unless previously provided in writing] For a purchase under a back-end load, the percentage of the back-end load if sold immediately, whether the percentage is based on the purchase price or the proceeds, the number of years for the back-end load to reach zero, and the commission paid to the dealer at the time of purchase:

For a purchase of a bond, the yield, credit rating and outlook:

Any other point of sale disclosure item that was unknown at the point of sale:

Whether the security was recommended by the adviser:

In aggregate (if applicable):

Total amount paid by the investor:

Total amount of commissions, spreads and front-end loads:

Net dollar amount of securities purchased:

Appendix D

Account Opening Information of Other Jurisdictions

This Appendix summarizes some of the approaches taken by other regulators aimed at improving the quality of account opening procedures and disclosure.

Account Opening Documents Required in Other Jurisdictions

Over the years other jurisdictions have directed their attention to improvements that could be made to account opening documentation, with the aim of increasing retail investors' level of understanding of investment issues and supporting informed choices. Some of these proposals, most recently from the United Kingdom, Australia and New Zealand, and also from the United States, are summarized below. We have used them as a reference in developing our Fair Dealing Document and related material. We believe that the Fair Dealing Model's account opening requirements are an optimal balance between copious prescribed language on the one hand and information gaps on the other.

United Kingdom

In "Reforming Polarisation: Removing the barriers to choice", a consultation paper issued in January 2003,[1] the Financial Services Authority (FSA) proposes to require advisers to give to investors, at the time of first contact, an initial disclosure document. This document is intended to provide investors with key information to help them decide whether the services offered by a firm are right for them. It would have content and be in a form prescribed by the FSA.

The content of the initial disclosure document is proposed to include:

- A statement that the document is a requirement of the FSA
- Whether products are available from the whole of the market, a limited number of companies, or a single company
- Whether or not the investor will be provided with advice and recommendations
- That the investor will receive a menu card with specific information about compensation
- That the firm is regulated by the FSA and the scope of its permitted business with respect to "packaged products"
- What the investor should do in the case of a complaint
- Whether the firm is covered by the Financial Services Compensation Scheme
- The nature of ownership or lending relationships between the firm and any product providers

An initial disclosure document would not be required for investors who are seeking execution services only.

1 http://www.fsa.gov.uk/pubs/cp/166/index.html.

Australia

Under the Financial Services Reform Act, which came into effect in 2002, a financial services provider generally must deliver a Financial Services Guide (FSG) to an investor before providing a financial service. If specified time-critical criteria are met, certain information may be provided orally in advance and the FSG delivered afterwards.

The purpose of an FSG is to provide investors with the information needed to make an informed decision about whether to acquire a financial service. It must include:

- The kinds of financial services offered
- Who will provide the services and how to contact and give instructions to the service provider
- Information about compensation (see Appendix F for more details)
- Details about any associations or relationships that might reasonably be expected to influence the service provider in providing the services
- If the advice provided is general rather than personal advice, a warning to that effect
- Information about dispute resolution procedures

A service provider may not describe itself as "independent" in an FSG unless various requirements relating to remuneration, volume bonuses, gifts, benefits, restricted product lists, associations and relationships are satisfied.

New Zealand

Since 1997 an investment adviser in New Zealand is required to provide specified information about the adviser before giving advice and an investment broker is required to provide specified information before receiving client money. Additional information is required to be disclosed as soon as practicable following a request and in any event within five business days.

The initial information required to be disclosed includes:

- Specified types of convictions, adjudications in bankruptcy, or prohibitions on taking part in management activities within five years preceding the advice
- In the case of an investment broker, a description of procedures relating to the receipt and disbursement of money or property

Information required to be disclosed upon request includes:

- The name of any relevant organization with which the adviser has a relationship and a description of the relationship
- The type of securities about which the adviser gives advice, including limitations to specific issuers
- Relevant qualifications, when those qualifications were obtained, and how the adviser's knowledge has been kept up to date
- The adviser's experience as an investment adviser
- Whether or not the adviser or an associated person has, will or may have an interest that is reasonably likely to influence the adviser in giving the advice, whether in terms of remuneration or otherwise, and the nature of that interest[2]

The government of New Zealand, on the recommendation of the New Zealand Securities Commission, has stated that the two-tier disclosure system will be abandoned and that information currently required to be provided only on request will become mandatory.[3] The Commission also has recommended the following additional disclosure requirements:

- The nature and rate of fees
- Whether the adviser is a member of a professional body
- Available dispute resolution facilities

2 Proposed to be changed from "interest that is reasonably likely to influence the adviser in giving the advice" to "material interest", with a further requirement to disclose material benefits.

3 "Investment Adviser Law Reform: Formal Recommendations of the Securities Commission" (2002), http://www.sec-com.govt.nz/publications/documents/formal/index.shtml, and "Law Reform: Investment Advisers – A Discussion Paper" (2001), http://www.sec-com.govt.nz/publications/documents/law_reform/index.shtml.

United States

A registered adviser in the United States that provides personal advice generally is required to furnish to each advisory client and prospective advisory client a copy of part of its registration application (Part II of Form ADV) or a written document, such as a brochure, containing the information required by the form. The document is required to be delivered at least 48 hours before entering into an investment advisory contract with the client. Alternatively, the adviser may deliver the document at the time of entering into the contract if the client is given a right of termination of five business days.

Part II of Form ADV includes the following:

- The approximate percentage of billings coming from each type of advisory service enumerated in the form
- The types of compensation arrangements used by the adviser, the fee schedule, and how a client may terminate an advisory contract before its expiration or get a refund
- The types of clients advised by the adviser
- The types of investments on which the adviser offers advice
- Methods of security analysis, sources of information and investment strategies used by the adviser
- The educational and business background of various specified individuals
- Other business activities of the adviser
- The types of registrations held by the adviser and its related persons
- The nature of the adviser's participation or interest in client transactions
- Information on the frequency, level and triggering factors for monitoring accounts, and the nature and frequency of reports

Appendix E

Ongoing Reporting and Monitoring

This Appendix includes:

1. Template for information to be included in periodic account statements under the Fair Dealing Model

2. Examples completed for our notional investor George of a typical account statement today, and of an account statement that would be prescribed under the Fair Dealing Model

3. Options for including mandatory risk measures and benchmarking in reports to clients

Content of Account Statements

The following table lists the information we propose to require for periodic account statements. On the following pages, we present a sample account statement that conforms to these requirements, and for comparative purposes, one that resembles a typical statement in use today.

Proposed Information Requirements for Account Statements

For each transaction during the period:
Date of transaction
Whether purchase or sale
Identification of security
Quantity
Price
Amount debited or credited to account
For each security in the portfolio:
Quantity held at end of period
Price at end of period
Market value at end of period
Return during period
Return over one-year or since beginning of calendar year
Whether the security was recommended by the adviser (unless all were recommended)
If a bond: yield, credit rating and outlook
A year-end summary showing quantity, adjusted average cost, adjusted book value, price on statement date, and market value on statement date
In the case of a mutual fund for year-end statements: total compensation to selling agent and to fund management company (excluding portion paid by the fund management company to the selling agent). See main body of Concept Paper, pp 80-83.
In aggregate:
Portfolio performance over the period
Portfolio performance over one year
Portfolio performance over five years
For portfolio performance over five years (or shorter number of years if account open for less than five years): comparison with the investor's goals, if applicable, and an appropriate benchmark
Information about the risk level and diversification of the portfolio, including a comparison with the investor's stated target, if any. Information about the risk level of each security is optional.
Total compensation paid to the selling agent during the year and total compensation paid to fund management companies

Sample Client Statements

Typical Portfolio Statement Today:

B I G B A N K   S E C U R I T I E S

George Investor's Monthly Statement

Net Asset Value

August 31, 2003	September 30, 2003
	$84,450

Security Description	Quantity	Adjusted Average Cost	Adjusted Book Value	September 30, 2003 Price	September 30, 2003 Market Value
Equity					
XYG Bank	200	$44.56	$8,912.00	$46.35	$9,270.00
DotCom	1000	$5.67	$5,670.00	$15.24	$15,240.00
Gov't of Canada Bond	100	$100.56	$10,056.00	$101.54	$10,154.00
Can 11/09-strip	200	$94.52	$18,904.00	$98.93	$19,786.00
Xvest	1000	$14.37	$14,370.00	$26.35	$26,350.00
Billfund	1000	$3.56	$3,560.00	$3.65	$3,650.00

Portfolio Statement under the Fair Dealing Model:

B I G B A N K   S E C U R I T I E S

George Investor's Monthly Statement

Securities	Purchase Date	Purchase Price	Quantity	September 30, 2003 Price	September 30, 2003 Market Value	Gross Return Since Purchase	Net Return Since Purchase	1-Year Return
XYG Bank	10-Jan-96	42.34	200.00	46.35	9,270.00	50%	48%	12%
DotCom	28-Feb-00	5.67	1,000.00	15.24	15,240.00	312%	262%	-58%
Gov't of Canada Bond	15-Sep-99	100.56	100.00	101.54	10,154.00	10%	7%	5.80%
Can 11/09-strip	01-Jun-99	94.52	200.00	98.93	19,786.00	124%	105%	3.50%
Funds								
Xvest	12-Sep-97	14.37	1,000.00	26.35	26,350.00	78%	53%	2%
Billfund	11-Mar-01	3.56	1,000.00	3.65	3,650.00	6%	3%	2%

Portfolio Overview

	% increase Last Quarter	% increase Last Year	% increase Over 5 Years	Vs. Goals
Portfolio Performance				
Advised Trades	5.2	7.5	6	-2
Unadvised Trades	-2.5	10.5	NA	NA
Benchmarks				
TSE300	3	1.5	12	
Balanced Portfolio	2.5	3.5	8.8	
3-Month Treasury Bill	1	3.8	5	

Net Return reflects all management expenses, trailer fees and other charges which will impact investor return.

Separate portfolio statements may be prepared for each relationship.

Ways of Measuring "Risk"

The Fair Dealing Model proposes that ways be found to enhance investors' understanding of risk both generally, as part of an education process that begins at account opening, and respecting the riskiness of specific investments as a part of point of sale disclosure and in periodic account statements. We are concerned with the latter issue here.

Ultimately, the accuracy of numerical risk assessments calculated for a security or group of securities is limited by the fact that these measures are compiled from historical trading data and guesses at the future. However quantitative measures can provide a quick, visual way to assess the performance of an investment portfolio and the wisdom of particular purchases and sales. We expect that, using the Concept Paper as a starting point, our industry Working Groups will give further consideration to the measurement of risk and the presentation of risk concepts to investors.

Measuring Risk for Individual Securities

Various mathematical formulas have been devised that attemp t to provide an objective measure of the risk a particular security. These assess the volatility of its past trading price as an indicator of the unpredictability of its trading price at points in the future.

Beta Coefficent. One way do this is to compute the beta coefficient, which compares a security's volatility to that of the market. Betas can be calculated over any reasonable time span from a year to over a decade. Alternative formulas have been developed in an attempt to increase the usefulness of the measurement. For example, greater weight can be put on the most recent volatility in the share price. However, formulas of this sort can still yield anomalous results if there are rapid changes in the circumstances of a particular company. Betas are most commonly applied to mutual funds, which have an unchanging business. For a commodity producing company in a cyclical industry a longer term of past volatility may be more informative if for much of the cycle there is little volatility in the share price, but with high volatility when the commodity price rises late in the cycle. Formulas based on historical price data also cannot be applied to companies that only recently went public. Finally, betas are of limited use in indicating the risk of loss of principal.

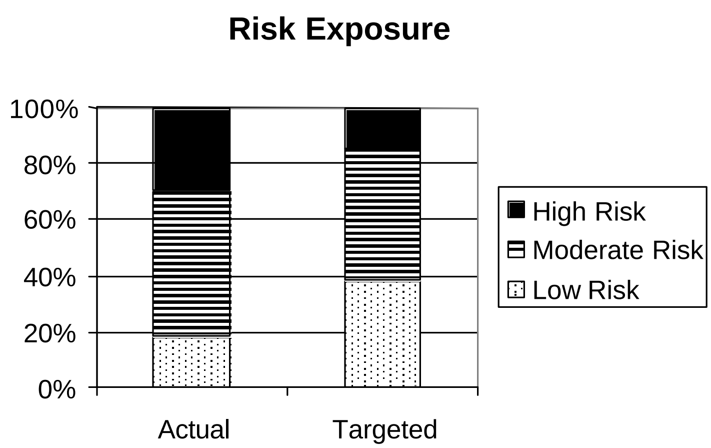
Standard Deviation. Another numerical method is based on standard deviations. While beta is a measure of the volatility of a security's trading price over time relative to the equity market, using standard deviations measures a security's intrinsic price volatility, independent of the market. This carries some advantage in terms of information to the investor. However, it is at best no easier for the average investor to interpret and there is no central source for this data that would be cheaply and easily accessible by intermediaries.

IDA Method. Another way to measure risk is to classify securities by price volatility, and either liquidity or credit ratings or both. The Investment Dealers Association has proposed a system using the average rate of change in security prices (standard deviations) and the average volume of securities traded to classify the risk of securities for margin requirements[1]. Securities with prices that move rapidly (volatility risk) or with low average volumes (low liquidity may create difficulties or higher cost in selling a security or buying back into a short position) represent a higher risk for the investor. While this is intended as a basis for setting margin rates, by classifying securities into the IDA's eight different risk categories, advisers and investors should be able to easily assess the degree of risk taken on an individual security. The project is also

1 IDA, "Equity Margin Project Discussion Paper" Draft #3, March 10, 2003

expected to identify acceptable hedges or risk offsets by security. The information is expected to be updated regularly and available to advisers, making this approach easy to implement and relatively low cost.

Presenting Risk of Individual Securities to Investors. As shown below, risk levels could be presented in a number of reasonably straightforward ways. High risk could be defined as any security with a beta in excess of 1.0; in other words, above market risk. Moderate risk would be consistent with the standard recommended portfolio of roughly 60% equities and 40% fixed income which typically generates a beta of around 0.7. For definitional purposes, the moderate range would have a beta of 0.5 to 1.0. A typical fixed-income portfolio carries a beta of around 0.3. The low-risk range could be defined as 0 to 0.5. As is the case with the IDA proposal above for individual securities, a higher number of risk classifications may be necessary. This analysis may also need to be sophisticated enough to identify risk offsets and the impact of diversification (see below).



Measuring Risk for Portfolios of Securities

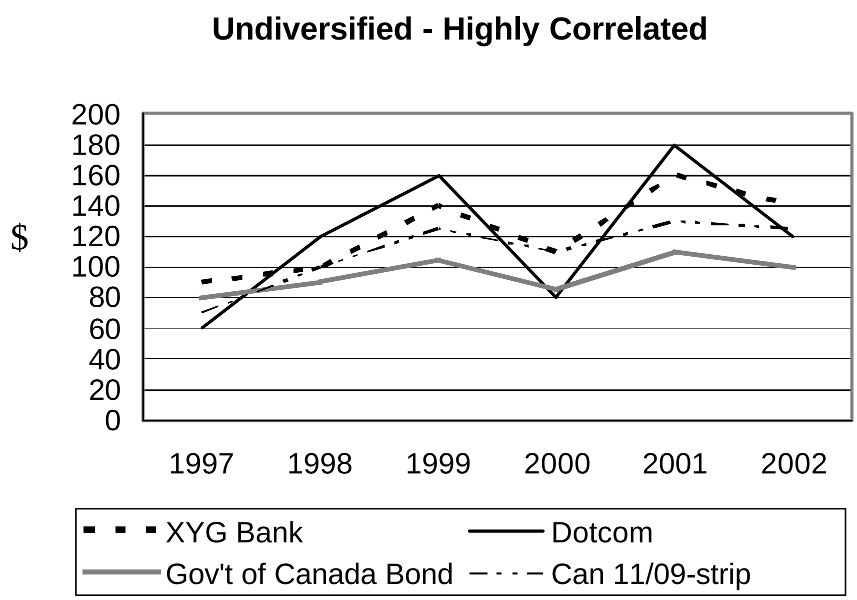
Information about the overall risk level of a portfolio might be more useful and could be provided more concisely than information about the risk level of each individual security. When one type of security is bought or sold, it could be of interest to know its effect on the risk level of the portfolio as a whole. Although an investor, or adviser, might have an intuitive sense of the risk level of individual securities, it can be more difficult to visualize how a number of securities interact to affect the risk level of a portfolio as a whole.

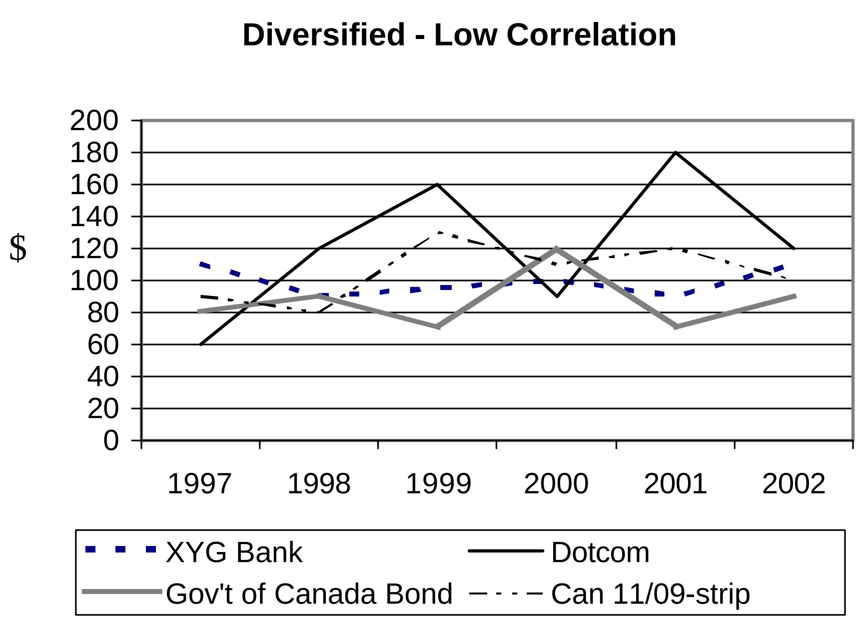
Diversification. Measuring diversification is central to determining a portfolio's level of risk. The diversification of a portfolio represents the degree of exposure to losses during a market downturn in any given sector. An undiversified portfolio, for example, with mostly equities in the high technology sector, would have taken the largest losses in the recent bear market. Shifting the portfolio to a more balanced or diversified selection of securities would involve trading high technology shares for equities in a wider range of industries and adding bonds, Treasury Bills or corporate paper and foreign securities. In other words, an undiversified portfolio consists mainly of securities that tend to move in the same direction at the same time. A diversified portfolio would generally rise less when securities in any given sector are moving up rapidly, but also be more protected from losses when those securities lose favour. This tends to produce a more predictable, stable return over the long term.

Information about diversification can be conveyed through percentage allocations among different classes of securities and, for equity, percentage allocations among different industry sectors. A correlation matrix also can be calculated in a basic spreadsheet to assess the degree of diversification in a portfolio.

The degree of diversification in the client's portfolio could be presented either graphically or numerically. Following are two examples taken from George's Statement.

*Graphical presentation***.** The graphs easily show whether the trading prices of George's securities rise and fall together or tend to offset each other. A portfolio with more volatile securities that have a tendency to move up or down at different times could be less volatile overall than a portfolio having lower risk securities that tend to move in the same direction.



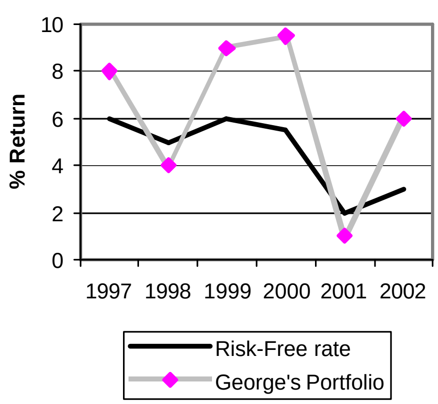


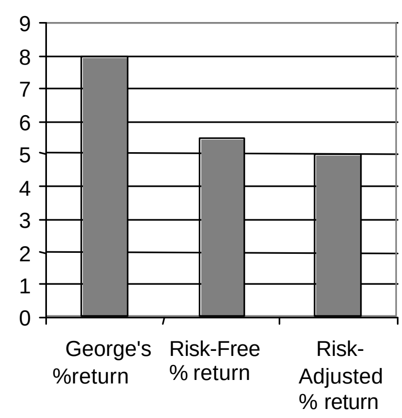
Numerical presentation. As an alternative to using a graph, one can calculate whether the prices of the securities in George's portfolio over a past time period have tended to rise and fall at the same time or not as the correlation coefficient, R^2. While investors may not be interested in the calculation method, they can appreciate that the higher the correlation in upward and downward movements of all the securities in the portfolio, the closer the R^2 value would come to 1, and the less diversified, more risky the portfolio. Conversely, the more often the prices of the portfolio securities rose and fell at different times, the closer the R^2 value would be to 0. Here, the portfolio shown on the top chart would have and R^2 of about 0.9. The bottom portfolio shown for George would have a more favourable R^2 value of 0.1 to 0.2.

Risk-Adjusted Yield. Investors also might benefit from information about risk-adjusted returns, which measure whether, for a given increase in risk, an investor is compensated by an equivalent improvement in return over the "risk-free" rate. Risk-adjusted returns provide a fairly objective method for tackling the issue of an investor's tolerance for risk. Two commonly used formulas are referred to as the Sharpe Ratio and Treynor Ratio. The Treynor ratio, which uses betas, is tied to an index, while the Sharpe ratio, which uses standard deviations, is not.

The concept of risk-adjusted return is popular with portfolio managers; presumably retail investors could benefit from access to the same information for managing their own portfolios. While the analytics may be somewhat technical and there may be debate over using the Sharpe Ratio rather than the Treynor Ratio, the interpretation is relatively straightforward. Is the nominal return of my portfolio high enough to compensate me for the degree of risk?

In the example below, George's portfolio earns a higher return than the "risk-free" rate, but is it enough? The risk-adjusted return is slightly lower than the risk-free rate. George's return is higher than he would earn on a Treasury Bill, but, as shown by the Risk Adjusted rate of return column, not high enough to justify the risk.



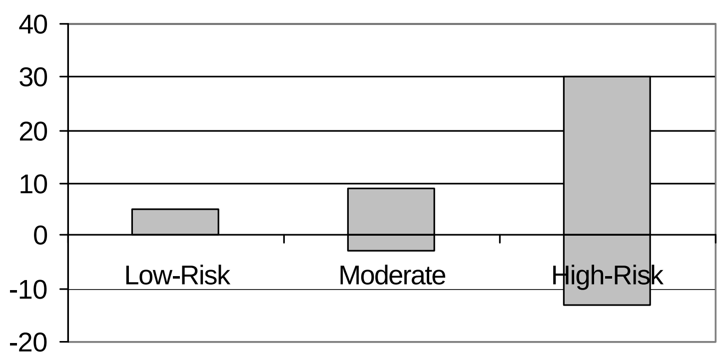


Value-at-Risk with Stress-Testing. A more sophisticated method of measuring risk is value-at-risk plus stress testing. Value-at-risk uses historical data to calculate the probability of a portfolio losing a specified amount no more than, say, 95% of the time. Stress testing modifies this by constructing "what if" scenarios and attempting to estimate the losses that would be incurred under extreme conditions. Stress testing is open to different approaches in application and a fair degree of subjectivity. Value-at-risk with stress testing represents an example of a best practice and it is not proposed to be required.

Value-at-risk (VAR) measurement was created to estimate the downside of a derivatives portfolio either 95 or 99% of the time, accounting for one or two standard deviations away from the mean or average value. Stress-testing is a relatively recent addition to this approach. It involves constructing extreme scenarios (the 1% to 5% not accounted for by the VAR estimation) and estimating the total losses under these scenarios. While constructed originally for portfolios of derivatives, VAR has been usefully extended to include more traditional securities.

The increasing availability of VAR software and relatively cheap data feeds (pricing traditional securities would already be vastly cheaper than for derivatives) may make this a viable option in retail investing within the next few years. This means that the concept of value-at-risk, rather than the calculation-intensive approach described above may soon be available to present risk information to the average investor. A series of hypothetical portfolios could be constructed, similar to those shown below, illustrating the range of performance an investor is likely to encounter given different groups of securities in their portfolios. This shows George that in any given year, the return on his portfolio should fall within the range shown.

Value-at-Risk



Higher returns should be compensation for more risk. George may not want to accept the risk of a loss in any year that goes hand in hand with the potential for higher return. Depending on George's risk tolerance (ability to withstand a loss and comfort level), he may choose a different portfolio construction. It is, however, conventional wisdom that over the long term the higher risk portfolio should outperform the others.

Currently, many advisory firms ask clients to choose between portfolios which represent different risk classes with both the upside potential and possible losses portrayed in a graphic format similar to the chart above. It is only reasonable, then, that this range be updated for the investor's portfolio on a periodic basis to ensure that both upside potential and downside risk remain within the range originally agreed upon.

Benchmarking

It has become increasingly common for investment returns to be benchmarked to a standardized market index. An issue on which comment is requested is whether the returns shown on reports, at least for advised and managed-for-you investors, should be required to be accompanied by benchmarking information showing how the longer-term returns compare to an index.

Advantages of Making Benchmarking Mandatory Under the Fair Dealing Model

Institutional investors have the bargaining power to demand that they be provided with comparative benchmarking information. It seems fair that retail investors should have the same information. Comparisons to benchmarks can put returns in perspective and enhance investor awareness of the performance of their advisers. Obtaining a return of 8% in a year when the market rose by 20% is very different from obtaining a return of 8% in a year when the market fell by 10%.

An investor is better able to assess the value of portfolio management services received if he knows how well his portfolio fared in relation to a benchmark, especially one that could be replicated by a low cost passively managed exchange traded fund. A large part of underperformance by retail investors is attributable to management fees and trading costs.[2] For example, if an investor knows that his portfolio of equity mutual funds has a 10-year return that underperforms the S&P TSX 60 by 3% per year, when the costs of active management over passive management are taken into account, he would see that negative value was received for the management of that part of the portfolio. Similarly, an investor could see that value was received in a year even when the portfolio of equity mutual funds lost money by comparison to an appropriate benchmark. In fact, wide public awareness of index benchmarks can encourage the use of low cost passively managed exchange traded funds because they are the most cost effective instruments for replicating an index.

Advisory firms routinely publish recommended asset mixes with the proportion of equities ranging from 40-70% (individual firms may have wider or narrower accepted ranges) with fixed income and cash making up the rest of the portfolio. It would be relatively simple to produce a benchmark based on the risk preferences and the lowest acquisition cost on an execution-only basis in order to allow the investor to estimate the cost and benefits of advice.

Disadvantages of Making Benchmarking Mandatory under the Fair Dealing Model

A fair deal implies a certain level of service and honest, competent advice that is not self-serving. It does not imply a maximisation of profits or the beating of a benchmark. Focus on a benchmark can distort investor goals by encouraging investors to try to beat the market rather than achieve realistic personal financial goals. Attempts by mutual fund and other investors to "beat the market" often have the contrary effect of lowering returns because they are chasing past performance. Studies have shown that the poor timing of many mutual fund investors' sales and purchases means their personal returns often significantly underperform the mutual funds in which they invest.[3]

---

2 See, for example, E. Dimson, P. Marsh, M. Staunton, Triumph of the Optimists: 101 Years of Global Returns, (Princeton University Press, 2002) p. 206

3 Johnston, "Feasibility Analysis for Risk Tolerance Assessment and Risk Awareness Training for Consumer Investors", prepared by Industrial Mathematics Lab Inc. in December 1997.

Benchmark data is readily available from daily newspapers and financial websites for retail investors sufficiently sophisticated to make use of it. While the Fair Dealing Model necessarily involves a considerable amount of prescription in order to fulfill its purposes, its aim is equally to avoid prescription where it is not needed. It is certainly arguable that providing benchmark data to investors is something that can be left to the market, and should not be the subject of prescription.

In a smaller market like Canada benchmarks might be less diversified than is desirable for an actual portfolio. For example, in 1999, managers of dividend funds and value-oriented funds were under increasing pressure to buy shares of Nortel so they would not lag the TSE index. Some fund management companies also applied to the Ontario Securities Commission for permission to purchase more shares of Nortel in funds whose Nortel holdings had reached 10% or more of net assets in an attempt to keep up with the TSE index.

Requiring benchmarking may increase pressure on service providers to make the portfolios of their clients match the benchmarks even though the financial service providers might view other investment strategies as being more advantageous in the long term. The desire to keep up with the index could encourage financial service providers to invest more in sectors more heavily weighted in the index than they would on the basis of active management principles. Tying management compensation to benchmarking can drive managers of portfolios that charge for active management to increasingly shadow the index. Investors continue to pay the higher fees for active management, while owning in effect a portfolio very similar to a passively managed portfolio that would have far lower fees.

Index comparisons can be subject to manipulation. For example, an equity portfolio advertised as benchmarked to the S&P TSX 60 might nevertheless have 20% of its investments in US equities. A portfolio might appear to be performing well in comparison to its benchmark during an extended down market simply because a significant portion is held in cash at all times.

Finally, designing an appropriate benchmark for a portfolio consisting of a variety of investments, such as shares, income trusts, long and short-term bonds and GICs, in varying proportions, can be complex and somewhat arbitrary. Indices have value as objective, passive measures of the collective performance of certain groups of traded securities. As index comparisons take on increasing significance in attracting assets under management, the pressure could increase to construct or adjust indices to validate management choices and styles, distorting the original role of indices as independent standards.

Guidance in Choosing Benchmarks

We request comment on the value of mandatory benchmarks in the main body of the Concept Paper, and we will revisit the issue with our Working Groups. If it is proposed to require benchmarking in reports, further comment will be sought on its parameters. We contemplate that we would at least require that any benchmarks chosen by a financial service provider should meet a minimum threshold of general acceptance as a reasonable point of comparison to a client's portfolio.

Appendix F

Compensation Biases

This Appendix presents a detailed discussion of embedded third party compensation structures and how they can contribute to a lack of transparency and to compensation biases.

This Appendix presents four anonymous case studies we have prepared using real, publicly available data only. The case studies illustrate the concerns raised in the Concept Paper regarding the impact of compensation biases on retail investors, and how embedded compensation structures reduce compensation and conflict transparency, even with full disclosure.

This Appendix also includes an assessment of how other regulators have responded to these concerns.

Sources and Impact of Compensation Biases

Transparency as a regulatory tool

In theory, disclosure of conflicts of interest acts to prevent self-serving outcomes by arming the investor with a clear sense of any potential divergence between her financial adviser's interests and her own. The investor can weigh the merits of the advice accordingly. Market forces then should operate to reward less conflicted advice.

Securities regulation in most developed financial markets relies on the assumption that if all relevant information is publicly available somewhere, the regulators have done their job to support investor decision-making and the proper operation of market forces. However, the Fair Dealing Model embraces the principal of transparency, i.e. understood disclosure. Traditionally, regulators have assumed it should be the investors' responsibility to assemble and weigh the information available to them. Given some of the complex distributors' compensation structures that drive the sale of investment funds, there is reason to question whether this is a fair assumption. It appears, for example, that few retail investors really understand what a trailer fee is, or its impact on their long term investment. Are investors too lazy to inform themselves, or is the problem something deeper? Is mandatory disclosure not enough to achieve transparency in some cases?

Testing Transparency

In this Appendix, we summarise some of the ways in which remuneration structures established by third party asset managers who are strangers to the adviser-client relationship can create potential conflicts of interest under our existing rules. We also present four case studies which we prepared using only publicly available information. Putting ourselves in the position of a public investor, we went through the exercise of collecting and compiling this information in the way an average investor would have to, in order to assess its personal significance. The result of this exercise was quite dramatic. We found that in each specific case there is reason to believe that adviser compensation rather than the best interests of investors is driving asset allocation choices to a significant extent, even though all the relevant information is publicly disclosed in some form. We also found that the amount of patient work necessary to reach these conclusions was beyond what we could reasonably expect of most investors. Although our examples are drawn from the mutual funds area, a similar analysis could be performed for segregated funds and other investment vehicles in which adviser compensation is embedded.

Evaluating conflicts

Before an investor allocates assets to even a plain vanilla investment fund, the factors relevant to conflicts in the advice he is receiving include:

1. Deciding between a front-end load and a back-end load purchase. Back-end load purchases often are considered to have at least a superficial appeal to investors because no direct commission is payable by the investor up front for the purchase. A proper evaluation of the consequences of these two options necessitates a more complex analysis.
2. Deciding between alternative redemption fee schedules in the case of a back-end load purchase, as offered by some mutual funds
3. Deciding whether to pay an additional amount for an asset allocation service built into the mutual fund purchases

4. Deciding among classes of funds where more than one class of fund might be available (*e.g.*, between an A Class fund with the adviser's compensation embedded in it or an F Class fund in which the adviser is compensated directly)
5. Considering the differences in trailer fees for each of these

Complicating the evaluation further is that these factors cannot necessarily be considered independently of one another. Compensation schedules often build in various interactions among them. For example, the amount payable for an asset allocation service might depend on whether the purchase is made with a front-end load or back-end load.

Investors' literacy levels

The International Adult Literacy Survey, a large-scale co-operative effort of the Organization for Economic Co-operation and Development, measured literacy in three areas relating to the ability to understand financial disclosure: prose literacy (the knowledge and skill needed to understand and use information from everyday text), document literacy (the skill needed to locate and use information contained in various formats), and quantitative literacy (the knowledge and skill needed to apply arithmetic operations to numbers embedded in print material). Forty-three percent of Canadians were found to have at least significant weakness in at least one of the three areas.[1]

What investors need to assess

Some of the potential biases created by third party compensation structures that an investor would need to be able to identify are:

- Commission differentials among similar asset management vehicles, including differences in the initial commission or in trailing fees. For example, a representative might receive a higher initial commission if a mutual fund is sold with a deferred sales charge, while the client believes it is commission-free.
- Compensation differentials among different asset management vehicles that achieve similar investment objectives. For example, a representative could receive significantly higher compensation as a result of recommending a portfolio of equity mutual funds rather than passively managed exchange traded funds or a portfolio of equity securities.[2] In general, the amount of compensation bears little relationship to the service provided.
- If a client has held a mutual fund until the deferred sales charge has fallen to zero, the representative has an incentive to recommend that the client switch to a similar fund managed by a different manager in order to collect another commission. The client again may believe the purchase is commission-free. In this case, the client might continue to own essentially the same investment without even receiving the benefit of avoiding a front-end load because no commission would have been payable at all by remaining a holder of the original mutual fund.

1 Statistics Canada, Literacy in the Information Age: Final Report of the International Adult Literacy Survey (1994).

2 Moreover, as a result of the compartmentalization of the licensing system, a dealer might be prohibited from recommending an asset transformation that would better serve the interests of the client.

- On average, representatives receive less compensation when their clients invest in income (bond) mutual funds than equity mutual funds or mutual funds with investments balanced between bonds and equity. This creates a financial incentive for representatives to recommend to their clients a lower asset allocation in bond mutual funds than might be in the best interests of their clients. It also creates the perverse result that a representative who goes to the trouble of helping a client allocate assets between a bond mutual fund and an equity mutual fund may receive less compensation than a representative who leaves the asset allocation responsibility entirely to a mutual fund manager by simply recommending to a client that all of the funds be placed in a balanced mutual fund.

- The representative might be compensated only if a recommendation results in the client making an investment even though a better recommendation from a client's perspective might be to do something other than investing, such as paying down debt.

- It is more profitable for a dealer to sell its own proprietary mutual funds managed within its group than mutual funds managed by a third party. One firm has stated that, as of early 2001, operating margins on its clients' assets managed by other firms were 0.05 to 0.1%, while operating margins on its clients' assets managed within its proprietary funds were 1.2 to 1.3%. National Instrument 81-105 (Mutual Fund Sales Practices) prohibits a firm from paying its representatives a higher proportion of commissions on its own mutual funds than on third party funds. However, the National Instrument does not deal with the situation of the dealer paying a representative an additional amount for using the dealer's asset allocation services or wrap accounts that invest only in the firm's proprietary products. The conflicts of interest created by a dealer's use of proprietary products are covered in Case Study 1 in this Appendix. Case Study 1 also involves certain other potential conflicts listed here. The particular conflicts concerns over the sale of proprietary products appear to apply only to firms in which the representatives recommend both proprietary and non-proprietary funds. The same concerns do not arise with respect to a firm where clients are aware that advice about fund investments is in the nature of asset allocation recommendations among proprietary funds only and the purchase of non-proprietary funds is just made available as an additional client service.

- If a representative is paid by commission, a recommendation for a client to borrow in order to invest results in the representative receiving higher compensation. If the dealer is the lender through a margin account, it earns additional income through the interest on the loan.

- Incentives based on the amount sold of a particular product create a conflict of interest. This conflict has been addressed in National Instrument 81-105.

- If an individual representative has a personal financial interest in a firm that provides products such as mutual funds, the representative might have a greater incentive to recommend that firm's products over similar third party products. That incentive could be immaterial to the representative if the firm is very large. However, if the representative is a major shareholder, as are the other representatives, the financial benefit arising from the ownership interest could exceed the commissions received from selling products, even though the representatives purport to be independent. The conflict mentioned in the previous paragraph is exacerbated if the representative has borrowed money to acquire the financial interest, due to leveraging and to possible increased pressure on the representative to earn as much as possible in order to pay the interest and principal on the loan.

As an indication of how complex these assessments can be, Case Study 2 in this Appendix provides the assessment an investor would have to make based on current disclosure to determine the possible effect of commission differentials between two mutual funds that otherwise are identical and between those two funds and a similar fund managed by the same fund management company. Case Study 3 in this Appendix compares the compensation structures for two very similar funds, one Canadian and one U.S., both managed within a Canadian-based corporate group. It considers the possible windfall compensation to dealers in certain circumstances where transparency may be lacking.

Third party compensation systems add complexity at each stage of the process. Before purchasing any mutual fund, the investor would need to have a general understanding of the compensation system. Much of the sample mutual fund information sheet deals with compensation (see Appendix B). At the point of sale, most of the information the investor would need in relation to a specific fund recommendation involves compensation (see Appendix C). The use of trailer fees might make it unfeasible or excessively costly to provide accurate information about costs in periodic reports (see p. 83 to 86 of this Concept Paper).

Impact of Fair Dealing Model Relationships

The discussion to this point has been based on client relationships as they exist today. Under the Fair Dealing Model, each of the three relationships must conform to our standards of conduct regarding management of conflicts. In the Self-Managed relationship this entails disclosure of costs and compensation alone. In the Advisory relationship, this entails disclosure of all cost and compensation as well as a requirement that the investment choices recommended to clients not be influenced by compensation differentials. But how realistic is this prohibition in the face of third party compensation structures that are designed to influence that advice? It would seem that duties of good faith alone are not generally perceived as effective by regulators. For example, under the present regime, despite the clear fiduciary duty that governs a discretionary portfolio manager, prohibitions against specified transactions considered to be conflicted are included in paragraph 227(2)(b) of the regulation under the Securities Act.

Practical limits of transparency

It also may be unrealistic to expect that representatives can provide all conflict-related compensation information to investors at the point of sale. For example:

- If a representative recommends a balanced fund, does complete transparency require the adviser to point out that separate equity and bond funds are available from the mutual fund company at a lower aggregate MER and pay a lower aggregate trailer fee?
- If a representative recommends an index mutual fund, does complete transparency require the adviser to point out that exchange traded funds are available for the same purpose at a much lower MER?
- More generally, if a representative recommends a mutual fund with embedded compensation, does complete transparency require the adviser to point out that comparable mutual funds are available without embedded compensation and consequently at lower costs?

One of the concerns we have heard from industry is that investors will resist reading large amounts of disclosure material. Is it possible to make third party compensation systems transparent to mutual fund investors without overburdening them with information? Providing excessive or complex information can be counterproductive as it may confuse investors and discourage them from using disclosure documents. The aim of disclosure under the Fair Dealing Model is transparency, or understood disclosure, not merely the production of information.[3]

Other ways to tackle compensation biases

If we cannot be sure that transparency can be achieved or be effective to control advice biases attributable to compensation embedded in investments, there are other solutions. Whether or not these are viable or necessary is a matter on which we expect to receive extensive stakeholder comment. While we have provided background material as a resource for further discussion, we have by no means come to any conclusions on these complex issues.

Eliminate embedded third party compensation. Conflicts fall away if third party compensation of advisers is eliminated, either voluntarily or as a result of legislation. In an Advisory relationship, the adviser and investor would remain free to choose the manner in which the investor pays the adviser. It could still be through commissions; it could be a percentage of the assets held in the investor's account; it could be an hourly fee; it could be an annual fee; or it could be a combination of these or something else decided between the adviser and the investor.

Advantages: The mutual fund industry is itself moving away from third party payment mechanisms in which the cost of the adviser's services is embedded in the fees paid to the mutual fund manager. Advisers increasingly are using compensation methods that better align the interests of the adviser with those of the investor. The most common alternative compensation option is a fee based on a percentage of the assets in the client's account.[4] In order to accommodate advisers charging asset-based fees or other alternatives, fund management companies have increasingly been unbundling the adviser's compensation from the management fee by offering F Class mutual funds. Advisers whose clients purchase F Class funds are not compensated by the fund management company.

The introduction of the F Class funds provides a means for the mutual fund industry to eliminate third party compensation schemes. All the industry needs to do is offer F Class funds exclusively. Advisers could then, for example, charge their investors fees based on the size of the account. Since the amount of work involved in providing advice tends to decrease as an account becomes incrementally larger, a certain percentage could be paid as a fee up to an amount A, a smaller percentage could be paid on additional amounts in the account up to B, and

---

3 Financial System Inquiry (Australia), Final Report, p.261. In a 1998 speech to a gathering of the Investment Company Institute, the then SEC Chairman asked: "Do you really expect investors to understand alphabet soup of A, B, C, D, I, Y and Z shares? To figure what combination of front-end loads, [contingent deferred sales loads], 12b-1 charges, commissions and who know what else they are paying?" http://www.gao.gov/new.items/gg00126.pdf p.77.

4 According to a study done by Investor Economics, from 1998 fee-based accounts at full-service brokerages were growing at an average annual rate of 79%. "A new deal from your broker: For those with hefty investment portfolios, fee-based advice is on the rise." Globe and Mail (Apr. 28, 2001). The amount in fee-based full service brokerage accounts at the end of 2000 was $16.6 billion of a total $414 billion in full-service brokerage accounts.

so forth. Investors with very large accounts might prefer to pay their advisers an hourly or an annual fee, while still compensating the advisers appropriately.[5]

A survey of 27 advisers who had switched to fee-based accounts found that 48% of the advisers gave concerns over conflicts of interest as the reason for making the switch. The advisers who switched returned to their pre-switch levels of compensation within three years.[6]

With an asset-based fee, the adviser's earnings increase as the client's assets grow. With a commission, the adviser's earnings increase as higher commission investments are recommended to the client. Higher commission investments often entail higher fee payments on the part of the client. The stated goal of recommending to a client the investments best serving the client is influenced by the relative remuneration received from various investments.

In the case of Self-Managed relationships, compensation might sensibly take the form of a flat fee paid at the time of purchase and possibly another flat fee paid at the time of sale, much like the payment of commissions on the purchase and sale of shares.[7] The service provided to the investor would seem to be a function of the number of trades made by their investor rather than their size.

Third party compensation schemes lead to inherent anomalies. For example, discount brokers, rather than being paid for the service they actually render of placing orders for the purchase and sale of mutual funds, are instead compensated through ongoing trailer fees, even though they provide no particular ongoing service in relation to their clients' mutual fund holdings. Advisers are paid more not for the quality of their services, but rather for convincing clients to make investments in products paying high compensation.

Drawbacks: There are also possible drawbacks of eliminating third party compensation schemes:

- Change entails costs. However, in this case the industry already has created the mechanism for change by offering F Class funds. Mutual fund managers will no longer incur the substantial costs of administering third party compensation systems, although dealers who do not yet have a system in place to collect fees from clients will need to do so. The alternative of trying to bring true transparency to a complex fee structure undoubtedly would entail significant costs of its own.
- There could be a temporary impact on the income of advisers. Indications are that it takes three years for advisers to return to their prior income levels after making the change. It is possible that this transition stage would be reduced if all advisers made that change at roughly the same time because advisers would not lose clients who moved their accounts in order to continue to receive "free advice". In addition, indications from the industry are that advisers are not negatively impacted by the switch over the long term. Data or anecdotal information on the impact on individual advisers is welcome.

---

5 This is discussed in greater detail in De Goey, The Professional Financial Adviser, (2003) pp. 117-43, from which we also borrowed the expression "embedded compensation".

6 "Your Guide to Building a Fee-Based Practice", Investment Executive (Jul. 2001).

7 The payments made to discount brokers on the purchase and sale of shares are commonly referred to as commissions, but in effect are trade execution fees.

- The current system is considered to allow the mutual fund industry to service clients with smaller accounts by allowing those accounts to be subsidized, in effect, by the higher profits earned from clients with larger accounts. However, an adviser charging fees as a percentage of assets similarly could create a fee schedule that entailed some subsidization of smaller accounts by larger accounts. To the extent the current subsidization relies on creating obscurity for investors through a complex compensation system, it cannot be justified.

- Restricting compensation methods is philosophically undesirable and contrary to the preference for a free market system and its efficiencies. However, it is questionable that there is a free market under the current third party compensation system because a fund management company seeking to market its funds through independent advisers as a practical matter is required to pay trailer fees. Otherwise advisers, other than those who are paid by their clients directly, generally will not sell their funds. As mentioned above, a system of direct compensation for advisers allows the market to operate more freely by enabling compensation to be negotiated between the adviser and the investor instead of being pre-set by a third party.

- Consumers are unwilling to pay for investment and financial planning advice and related services. However, consumers now pay separately for many services previously provided by banks and other institutions at no charge. UK consumer research shows that consumers state a willingness to pay once they understand the situation. The financial services industry may, in fact, need to educate the consumer about the value of its services, something it has been able to avoid doing for consumers who believe they receive the services at no cost. Finally, under the Fair Dealing Model the investor will remain entitled to agree with the adviser to pay the same types and amounts of compensation as the investor currently is paying. The difference is that the compensation will become more visible to the investor once it is direct. To the extent the investor has been unconcerned about the value received for the adviser's services in the mistaken belief those services did not cost anything anyway, the current regulatory regime is unacceptable.

- Embedded compensation relieves dealers of the burden of collecting fees from clients on a monthly or annual basis and it relieves investors of the burden of sending to the dealer periodic cheques. Although embedded compensation may optimize the convenience of payment, the absence of embedded compensation arrangements need not make it burdensome. To the extent sufficient cash is available in an account, payment can be deducted from the cash balance. To the extent an account includes a liquid security such as a money market fund that can be sold in any amount without cost, an investor can pre-authorize its use in paying the dealer. Other alternatives also are available, such as pre-authorized deductions from a bank account, as used by the automobile insurance industry.

Voluntary versus mandatory implementation. If a move away from third party compensation schemes makes sense for the mutual fund industry, this raises the question whether it is feasible to be left to the industry rather than put into effect through legislation. A legislative approach provides a number of advantages:

- An adviser may have a legitimate concern that charging fees to clients directly could give an advantage to competitors who hold themselves out as providing their services at no cost. Eliminating third party compensation schemes levels the playing field in this respect.

- If third party compensation schemes are disallowed, advisers are relieved of the burden of explaining to their clients that the adviser's switch to a direct compensation method is in the client's best interests and having to deal with clients who do not want to make the change.

- Eliminating third party compensation schemes would be a major step towards the professionalism of investment advisory and financial planning services and create a freer marketplace in those services. Rather than being paid more based on recommending higher commission products, advisers could be paid more based on their ability, experience and reputation. A newly licensed adviser could charge lower fees while building up a client base. A very experienced adviser whose services are widely sought could charge higher fees.

- The tracking and implementation of third party compensation schemes, such as trailer fees and deferred sales charges, place enormous costs on the mutual fund industry, costs that ultimately are borne by investors. Managers of mutual funds sold through independent advisers generally have no choice but to keep these costly systems in place, even as increasing numbers of advisers switch to F Class mutual funds. These costs will disappear if advisers who sell mutual funds are limited to F Class funds.

- Although it is expected that advisers who charge direct fees to clients will then sell them the less costly F Class funds, there is nothing, other than internal firm policy and their own integrity, to prevent those advisers from receiving additional compensation from uninformed clients by selling them funds with embedded compensation.

- The payment of compensation by third parties introduces uncertainty into the legal relationships among the parties. Payments intended to influence the advice of a firm or adviser who may be a client's agent become problematic if the compensation is not transparent. The payment structure creates a complex agency relationship where the adviser's firm acts in effect as both an agent for the fund and an agent for the client.

Place Clear Responsibility for the Actions of an Adviser on a Third Party who Compensates the Adviser. If third party compensation schemes remain in place, there should be more careful examination of what are, and ought to be, the legal implications of the complex relationships they create. The fund management company in its role as portfolio manager is acting as a fiduciary in its relationship with the fund's unitholders. If the fund management company also is paying compensation to the unitholders' advisers as its selling agents, it seems reasonable to recognise that the management company, as part of its fiduciary obligation, has some responsibility for the conduct of its agents in relation to the sale of its products. Conflicted adviser conduct that might raise concerns for a fund management company could include a purchase of one of its funds with a back-end load in a switch from an equivalent fund managed by another firm once the redemption fee on the other fund has fallen to zero. The nature of the fund management company's fiduciary duties could be clarified by legislation.

Place Ceilings on Particular Aspects of Third Party Compensation. The possible impact of specific compensation ceilings is illustrated by Case Study 3 in this Appendix. That case study compares a Canadian mutual fund with a U.S. mutual fund having the same investment objectives, the same individual managing their portfolios, and very similar portfolios. The fund management companies are part of the same Canadian-based corporate group.

In contrast to the generally unrestricted nature of Canadian compensation systems, Rule 12b-1 under the U.S. Investment Company Act of 1940 prevents mutual funds from incurring excessive sales and promotion expenses. This has resulted in the National Association of Securities Dealers, Inc. imposing certain dollar limits on mutual fund compensation. These include:

- Trailer fees (known as service fees in the United States) paid to dealers may not exceed 0.25% per year
- The fee charged to a mutual fund in connection with the cost of financing deferred sales charges (known as the distribution fee) may not exceed 0.75% per year. The distribution fee may be assessed only in connection with investments made with a deferred sales charge.
- If a mutual fund pays both a distribution fee and a service fee, the aggregate distribution fee it charges in connection with financing an investment made with a deferred sales charge may not exceed 6.25% plus interest at a rate of prime plus 1%.

It seems to us that the tracking required by the formula for limiting the aggregate distribution fee in the United States is excessively complicated. It may be possible, however, to introduce some simpler form of ceiling. For example, currently trailer fees in Ontario generally range from 0.25% to 1%. Limiting trailer fees to 0.25% should reduce the incentive on advisers to recommend mutual funds carrying higher trailer fees. Regardless of whether or not a trailer fee actually is earned through the provision of ongoing services, those services should not be any greater in relation to Company A's equity mutual fund than Company B's equity mutual fund.

Our preliminary view is that imposing compensation ceilings on third party payments has a number of key disadvantages compared to eliminating the payment of compensation by third parties entirely. First, it leaves in place much of the complexity of current compensation schemes. Second, it ultimately results in a more prescriptive regulatory regime. Third, the market in advice remains restricted and distorted. Nonetheless, it is an option that could be considered as an adjunct to third party compensation schemes.

Compensation Case Study 1: Converting Assets Under Administration to Assets Under Management

Background and Objective: The case study illustrates the types of conflicts of interest that might arise when a dealer sells both proprietary funds managed by itself or another firm in its corporate group and funds managed by firms with which it is unaffiliated. Another situation in which conflicts of this type can arise is in a firm that offers wrap accounts that include proprietary funds, earning fees that include both a wrap fee and a fund management fee, and also sells non-proprietary third party funds, on which it earns sales commissions and trailer fees. The Concept Paper addresses this issue by requiring compensation transparency and by requiring that representatives in advisory relationships not be influenced by compensation in the recommendations they make to clients.

Nature of Concern: The firm's advisers sell both proprietary and third party mutual funds. The firm holds itself out as featuring multiple brand-name managers. However, the firm attributes its potential for organic growth to the room available for it to increase its assets under management (AUM) as a proportion of its assets under administration (AUA), *i.e.*, increasing the proportion of its clients' assets held in its proprietary mutual funds. The firm's asset allocation service is available only to clients who invest in its proprietary funds.

Methodology: We reviewed the public documents for both the corporate entity and the mutual funds. We also reviewed additional material available on the corporate entity's website.

Financial Incentive for Firm: The firm stated that, as of early 2001, operating margins for its AUA range from 5 to 10 basis points of average total assets under administration and 5 to 10% of revenue. Operating margins for AUM, on the other hand, range from 120 to 130 basis points or 40 to 60% of revenue. According to the firm, for each $1 billion invested in its products, it can increase EBITDA margins from the sale of third-party products from 0.05 to 0.1% to combined distribution and manufacturing EBITDA of approximately 1.2 to 1.3%, or about $13 million. Potential investors are advised that, with only $4 billion of the over $26 billion currently invested in its products, there is substantial opportunity for organic growth.

Past Results: The following table shows the percentage of AUM/AUA for advisory subsidiaries that have been part of the corporate group for the indicated periods of time. The data are as of December 31, 1998.

Length of Time in Group	AUM/AUA
Six months to one year	11.4%
One year to two years	18.3%
Two years to three years	26.4%
More than three years	47.7%

The following table shows the amount, in billions of dollars, of AUA and AUM in Canada in each indicated quarter and the percentage of AUM/AUA for each.

Period	2000				2001				2002	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
AUA	22.1	21.5	21.4	21.0	19.5	19.3	17.2	18.2	18.8	17.8
AUM	3.7	3.8	4.0	4.1	4.2	4.4	4.4	4.9	5.4	5.6
AUM/AUA (percent)	16.7	17.7	18.7	19.5	21.5	22.8	25.6	26.9	28.7	31.5

How Potential Conflicts for Advisers are Addressed: According to its annual information form, the standard form of agreement normally entered into with senior advisers who have elected to acquire shares under its adviser share purchase program include provisions that quotas will not be imposed for the sale of any particular type or volume of products or services and that the advisor will have continued access to third-party products.

Remaining Sources of Financial Conflicts – Direct: The restrictions relating to conflicts mentioned above still allow advisers to receive higher compensation for selling proprietary products. This can happen in the following ways:

- The management fees on the firm’s funds are higher than the industry standard (*e.g.*, an MER of 3.1 to 3.2% on its equity funds). Approximately 57% of the total management fees received by the firm for the year ended December 31, 2000 on proprietary funds were used to pay for broker commissions and other marketing, promotional and educational activities.
- Clients pay higher fees for using the firm’s asset allocation service, which is available only if the assets are invested in the firm’s proprietary funds. The firm pays higher trailer fees on assets invested through its asset allocation service.

Remaining Sources of Financial Conflict – Indirect:

Advisers are encouraged to acquire equity in the firm, which makes two plans available for this purpose:

- A stock option to encourage share ownership by advisers who join the firm as a result of an acquisition
- A stock purchase plan, in which the firm contributes 15% of the amount contributed by an eligible adviser buying shares

Advisers are able to borrow money to purchase the firm’s shares. This leveraging, including the adviser’s ongoing borrowing costs, increases the adviser’s financial incentives. It also can create an incentive to earn the highest possible commissions in order to pay off the loan.

Compensation Case Study 2: Correspondence between Sales Compensation and Investors' Choices between Identical Funds

Background and Objective: We looked at how common it is for a mutual fund sold with a front-end load to have a "clone" fund that has the same portfolio, but is sold with a back-end load and a different management fee. A look at the relative MERs of Funds A and C below raised the question of what scenarios, if any, could cause an adviser acting in the best interests of the client to recommend the newer fund, which has a higher MER and back-end load. The case study was expanded to also include another similar mutual fund started by the fund management company, again with a higher MER than the original fund.

Methodology: We reviewed the prospectus for the three mutual funds and obtained additional information about the funds from a third party website.

Evidence of Conflict: The original mutual fund (Fund A) has relatively low costs for investors and low commissions for advisers. The fund management company starts another fund (Fund C) that is identical, except for higher costs and higher commissions. Before starting Fund C, it had started another new fund (Fund B) having a similar investment mandate, again with higher costs and higher commissions.

Some investors buy Fund C in preference to Fund A, which is identical other than being less expensive for investors and providing lower fees for advisers, under a full range of reasonable assumptions and scenarios. The more expensive Fund B is far more successful than Fund A in obtaining client assets to invest.

Fund Comparison:

	Fund A	*Fund B*	*Fund C*
Start date	**September 1, 1981**	**November 23, 1992**	**October 22, 1999**
Investment objectives and strategies	All three funds have identical objectives in seeking to provide strong capital growth with a high degree of reliability over the long term. They all invest primarily in common shares of Canadian companies. The investment strategies of the three funds are the same, except that Fund A and C's stated objectives include investing in companies that have shown an ability to recognize opportunities for business expansion or whose management has shown strong entrepreneurial skills. Fund B's stated objectives include investing in companies that possess strong management and companies that are believed to be undervalued in relation to their intrinsic value.		
Portfolio management	Manager A	Manager B	Manager A The portfolio is identical to Fund A portfolio
Nature of load	Front-end load of 0 to 5%	Choice between front-end load that is the same as for Fund A or back-end load that is the same as for Fund C	(Based on deferred sales charge option) Back-end load – percentage of original cost: Year 1 6.0% Year 2 5.5% Year 3 5.0% Year 4 4.5% Year 5 3.0% Year 6 1.5% After 0.0% Management company pays dealer an initial commission of 4.9%
Management fee	1.75% on first $200 million of net assets; 1.50% on net assets in excess of $200 million	2.00%	2.00%
Trailing fee	0.30%	1.00%	0.50%
Payment of expenses	The manager pays all operating expenses except for brokerage commissions and fees and taxes.	Fund is responsible for the operating expenses that relate specifically to the fund and for its proportionate share of the operating expenses that are common to other funds.	Fund is responsible for the operating expenses that relate specifically to the fund and for its proportionate share of the operating expenses that are common to other funds.
MER (2001)	1.64%	2.43%	2.59%
Ten-year performance	9.87% (from Sept. 1, 1992 to Aug. 31, 2002)	10.0% (from Nov. 23, 1992 to Aug. 31, 2002)	N/A
Net sales from November 1992 (start of Fund B)	$21 million	$1,559 million	N/A
Change in size of fund from December 1999 to August 2002	Decrease of $90 million		Increase of $118 million
Amount of assets	$1.81 billion	$3.47 billion	$125 million
Length of prospectus	334 pages	334 pages	334 pages

Comparison of Proceeds Received for Investment in Funds A and C:

Funds A and C are identical except for their fees, costs and expenses. This allows a comparison to be done between the result of investing in those two funds knowing that their market returns, before the deduction of fees, costs and expenses, will always be the same. The tables below show the proceeds after specified periods of investing $1,000 in each of the two funds. The following assumptions are made in the calculations:

- Market returns (before deduction of fees, costs and expenses other than brokerage costs) of 10% (more typical) and 18% (high). Lower market returns favour Fund A more than indicated in the tables.
- Front-end load of 5%, the highest possible. Front-end loads of 1 to 2% are more typical. Fund B is assumed to have been sold under the deferred sales charge option rather than the low load option.
- An MER of 1.64% for Fund A and 2.59% for Fund C, their MERs for 2001
- After the first year, the right to redeem 10% of the total units of Fund C free of charge, which effectively reduces the total redemption fee on all the units by 10%
- The short-term trading charge for an immediate sale is ignored
- The proceeds were determined using the OSC mutual fund fee calculator, at http://www.investored.ca/en/interactive/mffcalculator/calculator.htm

10% Market Return	Fund A	Fund C
Immediate sale	$950	$940
Sell after one year	$1,029	$1,023
Sell after two years	$1,114	$1,106
Sell after three years	$1,206	$1,194
Sell after four years	$1,306	$1,298
Sell after five years	$1,414	$1,408
Sell after six years	$1,531	$1,524
Sell after seven years	$1,658	$1,635
Sell after eight years	$1,795	$1,755
Sell after nine years	$1,944	$1,882
Sell after ten years	$2,104	$2,019

18% Market Return	Fund A	Fund C
Immediate sale	$950	$940
Sell after one year	$1,104	$1,102
Sell after two years	$1,283	$1,282
Sell after three years	$1,491	$1,487
Sell after four years	$1,733	$1,733
Sell after five years	$2,014	$2,013
Sell after six years	$2,340	$2,334
Sell after seven years	$2,720	$2,689
Sell after eight years	$3,160	$3,097
Sell after nine years	$3,673	$3,567
Sell after ten years	$4,268	$4,108

Analysis:

1. The difference in proceeds from investing in Funds A and C grows rapidly beyond 10 years as a result of the large difference in the MERs.
2. Under none of the scenarios, including the relatively extreme case of a 5% front-end load for Fund A and a market return of 18%, does the investor benefit from investing in Fund C rather than Fund A. However, while Fund C grew by $118 million from December 31, 1999 to August 31, 2002, Fund A decreased in size during that period by $90 million. The beneficiary of higher sales of Fund C is the dealer, who receives a trailer fee of 0.5% instead of 0.3%.
3. The same precise comparison cannot be made between Fund A and Fund B because their portfolios are not identical. However, they have the same investment objectives, very similar investment strategies and similar performance. Nonetheless, since the inception of Fund B, Fund B has had net sales of $1,559 million, while Fund A has had net sales of just $21 million. Sales of Fund B greatly benefit the dealer, who receives a trailer fee of 1% on this fund as compared to 0.3% on Fund A.
4. The larger Fund A grows above $200 million in assets, the lower its management fee. Any diversion of potential inflows from Fund A to Fund C, which has the same management and investment portfolio as Fund C, acts to the detriment of the existing investors in Fund A by increasing the management fee they pay. The fund manager receives the same economies of scale in managing the portfolio whether funds come into Fund A or Fund C, but it passes on some of those economies of scale to the investors only if the funds come into Fund A.
5. Besides receiving a larger management fee from investors in Fund C, the fund manager also benefits from the formation of Fund C in being able to obtain reimbursement for expenses from the newer fund, which it is not able to obtain from Fund A. The expenses portion of the 2001 MER was a relatively high 0.59%.

Compensation Case Study 3: Effect of Back-End Loads on Fee Structures

Background and Objective: A Canadian based corporate group managing very similar mutual funds in both the Canadian and U.S. markets allows a relatively controlled comparison to be made between Canadian and U.S. fee structures. In particular, two significant differences exist relating to third party compensation structures that are regulated in the United States, but not in Canada, where lack of transparency may have resulted in a failure of competitive pressures to function adequately. As a result, this case study gives some indication of the cost of lack of transparency. This case study also addresses common misconceptions in comparing mutual fund fees in the two countries arising purely from differences in the ways fees are labelled. The Concept Paper raises the question of whether improved transparency would suffice to address the problem or whether additional measures are needed.

Nature of Concern: The lack of true transparency about third party compensation in the mutual fund industry may result in investors paying excessive fees in some situations and certain service providers receiving compensation windfalls. Although transparency issues also exist in the United States, they have been addressed in part through regulatory action in the United States prohibiting the payment of particular amounts considered excessive.

Investors in the two mutual funds pay similar fees in the initial years if a purchase is made with a back-end load (deferred sales charge). However, the fees are significantly higher for the Canadian fund if a purchase is made with a front-end load or in later years if a purchase is made with a back-end load.

Methodology: We reviewed prospectuses for the two mutual funds and obtained additional information about the funds from third party websites. We also reviewed the applicable U.S. requirements.

Fund Comparison:

	Fund A	**Fund B**
Country of fund	Canada	United States
Portfolio management	Same employee of U.S. fund management company. Funds invest in common shares of U.S. small to mid-capitalization companies with above average growth prospects. Holdings are very similar, though not identical. As of September 30, 2002, the nine largest holdings of the two funds were the same, though not in identical proportions or in exactly the same ranking.	
Size of fund	Cdn$98 million	US$31 million
Front-end load option	Maximum of 5%	Maximum of 5.75%
Back-end load option	Redemption schedule: 1st year 5.5% 2nd year 5.5% 3rd year 4.5% 4th year 4.0% 5th year 3.5% 6th year 2.5% 7th year 1.5% 8th year 0.0% 10% redeemable without charge Manager pays a 5% sales commission to dealers at the time of sale.	Redemption schedule: 1st year 5.0% 2nd year 4.0% 3rd year 3.0% 4th year 3.0% 5th year 2.0% 6th year 1.0% 7th year 0.0% Manager pays a 4% sales commission to dealers at the time of sale.
MER under front-end load option	2.54%, consisting of: Management fee 2.00% Other expenses 0.54% (including GST)	1.8%, consisting of Management fee 0.85% Service fee 0.25% Administrative fee 0.10% Other expenses 0.60%
Initial MER under back-end load option	2.54%, consisting of: Management fee 2.00% Other expenses 0.54% (including GST)	2.61%, consisting of Management fee 0.85% Service fee 0.25% Administrative fee 0.10% Distribution fee 0.75% Other expenses 0.66%
Subsequent MER under back-end load option (after approximately eight years)	2.54%, consisting of: Management fee 2.00% Other expenses 0.54% (including GST)	1.8%, consisting of Management fee 0.85% Service fee 0.25% Administrative fee 0.10% Other expenses 0.60%
Trailer fees (service fees under U.S. terminology)	1% if purchased with a front-end load 0.5% if purchased with a back-end load	0.25%

Note: The management fee for the Canadian fund (inclusive of trailer fees and financing costs, which are bundled into it) corresponds to the management fee plus service fee plus administrative fee plus distribution fee for the United States fund, which are separately shown unbundled.

Regulatory Background:

Rule 12b-1 under the U.S. Investment Company Act of 1940 prevents mutual funds from incurring excessive sales and promotion expenses. It has resulted in the National Association of Securities Dealers imposing certain numerical limits on mutual fund compensation, including the following:

1. Trailer fees (known as service fees in the United States) paid to dealers may not exceed 0.25% per year
2. The fee charged to a mutual fund in connection with the cost of financing deferred sales charges (known as the distribution fee) may not exceed 0.75% per year. The distribution fee may be assessed only in connection with investments made with a deferred sales charge.
3. If a mutual fund pays both a distribution fee and a service fee, the aggregate distribution fee it charges in connection with financing an investment made with a deferred sales charge may not exceed 6.25% plus interest at a rate of prime plus 1%

Analysis:

The MER in the initial years for a purchase made with a deferred sales charge is similar for the Canadian and U.S. funds, 2.54% for the Canadian fund and 2.61% for the U.S. fund. However, after eight years the MER for the U.S. fund falls to 1.8%, while the MER for the Canadian fund remains at 2.54%. At this point the Canadian investor no longer receives a monetary benefit for continuing to be a long-term holder of the fund because the redemption schedule amount has already fallen to zero. Instead, once the Canadian fund management company has been compensated for the cost of financing its payment of an up-front commission to the dealer when the purchase is made with a deferred sales charge, the management company receives a windfall from the investor.

An investor purchasing with a front-end load in the United States pays an MER of only 1.8%, as compared to 2.54% paid by a Canadian investor. A Canadian investor making a purchase with a front-end load is required to pay the same annual fees as a Canadian investor making a purchase with a deferred sales charge even though the fund management company does not incur any financing costs for the front-end load purchase.

The additional amount paid by the Canadian investor is largely passed on to the dealer because the trailer fee paid on a front-end load purchase is 1%, as compared to a trailer fee of 0.5% paid on a back-end load purchase. On the assumption that the actual costs of servicing an account on an ongoing basis is comparable in Canada and the United States and this cost, as determined by the National Association of Securities Dealers, should not exceed 0.25%, Canadian dealers receive a windfall payment of 0.75% per year on front-end load purchases and 0.25% per year on back-end load purchases. This difference of 0.75% per year on front-end load purchases corresponds almost exactly to the 0.74% difference in MERs between the Canadian and U.S. funds.

Since the stated up-front commissions on front-end load sales are only maximum commissions, a Canadian dealer could choose to return some of its windfall back to its clients through reductions in the negotiable up front commissions. Nonetheless, a long-term Canadian investor paying a front-end load even as low as 0% ultimately would be paying a higher aggregate compensation to the dealer than the long-term U.S. investor. Even a Canadian dealer that charges the full 5% front-end load, without any reduction, remains entitled to the full 1% trailer fee.

The table below shows the proceeds each year of investing $1,000 in each of the Canadian and U.S. funds on a front-end load basis and the additional proceeds received by an investor in the U.S. fund. For this comparison it is assumed that the investor in the Canadian fund initially pays a reduced commission of 2% and the investor in the U.S. fund initially pays the maximum commission of 5.75%. The MER differential is assumed to be 0.75%, the difference between the Canadian trailer fee and U.S. service fee, using an MER of 2.55% for Canada and 1.8% for the United States. The market return, before deduction of the MER, is assumed to be 10% per year. The proceeds were determined using the OSC mutual fund fee calculator, http://www.investored.ca/en/interactive/mffcalculator/calculator.htm.

Years Held	Canadian Fund	U.S. Fund	Difference
One	$1,051.76	$1,018.94	-$32.82
Two	$1,128.78	$1,101.57	-$27.21
Three	$1,211.43	$1,190.91	-$20.52
Four	$1,300.14	$1,287.49	-$12.65
Five	$1,395.34	$1,391.91	-$3.43
Six	$1,497.51	$1,504.79	$7.28
Seven	$1,607.17	$1,626.83	$19.66
Eight	$1,724.85	$1,758.77	$33.92
Nine	$1,851.16	$1,901.40	$50.24
Ten	$1,986.71	$2,055.61	$68.90
Eleven	$2,132.18	$2,222.32	$90.14
Twelve	$2,288.31	$2,402.55	$114.24
Thirteen	$2,455.87	$2,597.39	$141.52
Fourteen	$2,635.71	$2,808.04	$172.33
Fifteen	$2,828.71	$3,035.77	$207.06

If the reduced proceeds of $207.06 per $1,000 investment after 15 years were to apply to an entire $100 million fund, the aggregate proceeds lost to investors after the 15 years would be $20,706,000.

Compensation Case Study 4: Compensation Trends over Time for an Equity Mutual Fund

Background and Objective: Various changes have taken place in mutual fund compensation structures and amounts over the past 15 years. This case study traces those changes.

Nature of Concern: Inadequate transparency over management fees of mutual funds might inhibit competition in their pricing. While the more visible loads have decreased over time, management fees have increased.[8] This increase has happened despite large increases in the amounts under management, which should have been expected to create economies of scale.

Methodology: We reviewed the compensation information contained in documents filed by a major Canadian equity mutual fund from 1985 to 2002. We also reviewed similar documents for several other major Canadian equity mutual funds for portions of that period. The reviewed fund was selected based on the availability of a more complete record over the entire time period. The information obtained from the other funds was used to verify that it was reasonably representative of industry practice.

Summary: The mutual fund's management fee was increased and the provision for the fee to decline with increasing assets in the fund was removed. A trailer fee paid to dealers out of the management fee was introduced and later increased for purchases made with front-end loads. However, the maximum front-end load for the fund was lowered and the redemption fee schedule for back-end load purchases was shortened. A second fund was started with an even higher management fee, but the same investment objectives and managers.

---

8 The pattern of greater investor awareness and price competition over front-end loads was observed in the United States by the General Accounting Office in its report dated June 2000 entitled "Mutual Fund Fees: Additional Disclosure Could Encourage Price Competition", pp. 74-76.

Compensation History from 1985:

1985: Front-end load only. Maximum varies from 3 to 9%, depending on the amount invested. If the amount is below $15,000, the maximum is 9%.

The management fee is 1.5% on the first $100 million of the fund's assets, then 1%.

1987: The management fee is increased to 2%. It does not decrease as the fund grows.

1988: Trailer fee of 0.5% payable to dealers begun.

1990: Back-end load option begun.

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**After**
Percentage	5.5	5.5	5.0	4.5	4.0	3.5	3.0	2.0	1.0	0.0

The dealer receives a 5% commission on back-end load sales.

Maximum commission for front-end load sales lowered to 6%, which is applicable if the amount invested is below $30,000.

1993: Temporary bonus incentive program of up to 0.75% of net sales exceeding a specified amount.

1994: Temporary bonus incentive program percentage increased to 1%.

1996: New fund started with the same investment objectives and strategies, the same managers and very similar portfolios, but with a higher management fee of 2.25%. The original fund with the 2% management fee was closed to new investment approximately one month later, although it has subsequently been reopened.

New back-end load schedule.

Year	**1**	**2**	**3**	**4**	**5**	**6**	**After**
Percentage	6.0	5.5	5.0	4.5	4.0	3.5	0.0

No redemption fee is charged on a redemption of 10% of the units held.

1997: Up to 1% available to assist dealers in marketing the funds.

2000: Trailer fee increased to 1% for new units sold with a front-end load.

F Class units introduced with a management fee of 1% and no trailer fee.

Analysis:

1. In 1987 the management fee was increased to 2% from a basic level of 1.5%. In addition, while mutual funds enjoy strong economies of scale as they grow, the reduction of the management fee at the $100 million asset level was eliminated. The removal of a tiered management fee was common among mutual funds at the time. Currently the fund and its "twin fund" have net assets of approximately $3.5 billion. Thus the management fee is nearly double the amount that currently would have been payable under the earlier fee schedule.
2. With the introduction of a 0.5% trailer fee in 1988, much of the increase in the management fee is for ongoing payments to dealers who sell the fund. The trailer fee was increased in 2000 to 1% for units bought with a front-end load. The trailer fee is payable whether the dealer provides advisory and other financial services on an ongoing basis or, as in the case of discount brokers, it does not do so.
3. The introduction of a "twin fund" in 1996 effectively increased the management fee further.

The maximum front-end load that may be charged has been lowered from 9% to 6%. This is the most visible fee. The redemption fee for back-end load sales goes to zero after six years rather than after nine years, although the fee during the initial six-year period is roughly the same as before.

How Other Jurisdictions Have Identified and Tackled Retail Adviser Compensation Biases

Concern that the compensation methods developed by the financial services industry may result in a lack of alignment between the interests of retail investors and their advisers is by no means unique to Canada. Reports in the United Kingdom, United States, Australia and New Zealand have also found problems with inadequate transparency and conflicts of interest in connection with compensation practices.

Identifying Problems

United Kingdom. "Medium and Long-Term Retail Savings in the UK: A Review by Ron Sandler" was submitted to the Chancellor of the Exchequer in July 2002 with the goal of identifying "the competitive forces and incentives that drive the industries concerned, in particular in relation to their approaches to investment and, where necessary, to suggest policy responses to ensure that consumers are well served." The Sandler Report concluded that:

> "Consumers rely heavily on advice from intermediaries, although they have almost no understanding of the costs of obtaining this, and are unable to gauge its quality. Moreover, the advice itself is often compromised by the incentive effects of commission paid by product providers.
>
> "Partly as a result, competitive forces do not always work effectively to deliver value."[9]

The Sandler Report was concerned that, as a result of perceiving advice to be free, investors fail to exert effective competitive pressure on the quality and value of the advice they receive.[10] The report further states:

> "Commission-driven selling of these products remains the norm, leading to persistent concerns about consumer detriment and to consequent regulatory intervention. Recent research by the FSA found statistically significant evidence of advisers recommending one provider's offering over another because it paid a higher commission."[11]

This research mentioned in the Sandler Report is contained in a report on "The Effect of Commission Based Remuneration on Financial Advice" submitted by Charles River Associates Ltd. to the Financial Services Authority (FSA) in December 2001[12]. In 1995 a requirement had been imposed in the United Kingdom requiring salespersons to disclose their remuneration to purchasers of packaged investment products in a "key features document" at the point of sale.

Charles River used statistical and market research data to look for systematic evidence of commission bias in recommending investment products or providers of those products. It

9 http://www.hm-treasury.gov.uk/documents/financial_services/savings/fin_sav_sand.cfm, pp. iii & 1.

10 Id. p. 187.

11 Id. p. 2.

12 http://www.fsa.gov.uk/pubs/other/pol_res1.pdf.

obtained the market research data by carrying out "mystery shopping" exercises with financial advisers. Charles River looked at two scenarios, a lump-sum investment and an ongoing stream of funds, and visited both independent advisers and advisers tied to product providers. It was able to obtain usable data from 179 visits.

Charles River found data suggesting that commissions influence advisers' recommendations at both the product level and the provider level. It found that bias was more prevalent among independent advisers than among advisers tied to particular providers. The 179 sets of data were divided among two scenarios, two types of advisers, and a variety of product recommendations. The finding of commission bias was limited to certain types of products. Charles River did not find evidence of bias for other products, but its analysis was limited by the very small sample sizes for many of the products. Charles River also was conservative in its analysis in recognition of extraneous factors affecting the recommendations. The study did not look at bias in advice between recommending the purchase of a commissioned product and no product at all or a non-commissioned product.

Relying in part on the Charles River research results, the FSA published a Consultation Paper in January 2002 entitled "Reforming Polarisation: Making the market work for consumers". The FSA found that the bundling of adviser compensation with the cost of the product to the investor makes the compensation system incomprehensible to investors. According to the FSA's research:

> "Most consumers think the product provider bears the cost of commission or they do not think about it at all. Only the most financially sophisticated understand that the commission the adviser receives will come out of the charges on the product they buy. When they do understand the position, most consumers think commission may bias advice and say they would prefer to pay a fee for independent advice."[13]

The UK had previously modified its regulatory system to address the lack of clarity whether an adviser was acting on behalf of a product provider or on behalf of an investor. This lack of clarity had been found to exacerbate conflicts of interest relating to compensation. The FSA was concerned that the solution previously adopted created anti-competitive practices and had other negative consequences, but in looking for alternative solutions the FSA acknowledged that this potential lack of clarity still needed to be addressed.[14]

United States. The U.S. Securities and Exchange Commission (SEC) formed a broad-based Committee on Compensation Practices to consider conflicts of interest in the retail brokerage industry, which issued its report in April 1995. The Committee found that conflicts of interest persist in the commission-based compensation system then in use. The Committee concluded that this commission-based system inevitably creates conflicts of interest, although "it works remarkably well for the vast majority of investors". The majority of Committee members "would not design a compensation system based only on commissions paid for completed

---

13 http://www.fsa.gov.uk/pubs/cp/cp121.pdf pp. 5 & 18. The FSA's research further found that consumers considered the services of independent financial advisers to be worth £70 per hour. Id. p. 19. The FSA indicated some doubt whether a stated willingness to pay a fee would apply in the real world. Id. p. 39.

14 Id. pp. 12 & 29.

transactions". Particular concerns that the Committee considered to be remediable within the existing compensation system included:

1. The lack of disclosure about extra compensation paid in connection with the sale of particular products
2. Clients not being adequately informed about the risk and actual returns of their investments[15]

In June 2000 the United States General Accounting Office (GAO) prepared a report entitled "Mutual Funds: Additional Disclosure Could Encourage Price Competition". The GAO agreed with the view expressed by private money managers and academic researchers in the United States that, despite the disclosure made about fees at point of sale, the information provided to mutual fund investors does not make investors sufficiently aware of the level of fees they pay because it fails to include the actual dollar amounts paid. The GAO also indicated acceptance of the view that this information could reinforce to investors that they pay fees on their mutual funds and provide information to investors that is useful in evaluating the services they receive. The GAO report referred to evidence that investors have greater awareness of the more visible front-end loads charged to their accounts, which, in contrast to annual fees, had resulted in a significant decline in front-end load amounts from approximately 8.5% in 1980 to approximately 5%. The report also cites a statement by the SEC Chairman in congressional testimony that only one fund investor in six understood that higher expenses could lead to lower returns and only one in five could give any estimate of expenses for their largest mutual fund holding. Other research found that about 40% of surveyed fund investors incorrectly believed that a fund's annual operating expenses did not affect its gains.[16]

On December 19, 2003 the SEC issued a concept paper requesting comment on measures to improve the disclosure of mutual fund transaction costs.[17] The SEC was concerned that these costs can be substantial, commissions and spreads together costing an average equity fund as much as 0.75% according to the estimates in one study. It also was concerned that these costs subject fund managers to conflicts of interest, such as when they are used to pay for research and other expenses that otherwise would be paid by the fund manager. The SEC requested comment on various options for more meaningful quantification of transaction costs that are easily measured, such as commissions. It also requested comment of various options for attempting to quantify transaction costs that are less easily measured, including spreads, market impact costs when the price of a security changes as a result of the effort to purchase or sell the security, and the opportunity cost of missed trades when the price of a security rises or falls after an investor has decided to buy or sell a security, but before the transaction can be executed.

Australia. In September 2002 Ian Ramsay released a report to the Australian Securities and Investments Commission on the "Disclosure of Fees and Charges in Managed Investments". Many of the concerns expressed in this report dealt with inadequacies in prospectus disclosure already addressed in National Instruments 81-101 and 81-102. Like the GAO, the Ramsay Report also was concerned with the lack of disclosure about fees in periodic statements provided to investors:

---

15 http://www.sec.gov/news/studies/bkrcomp.txt pp. 3 & 16.

16 http://www.gao.gov/new.items/gg00126.pdf pp. 72-78.

17 http://www.sec.gov/rules/concept/33-8349.htm

> "This is unfortunate because it is this document which provides the opportunity for an investor to ascertain precisely what fees and charges have been paid in relation to the investment. . . . I view this situation with the utmost concern."[18]

New Zealand. "Law Reform: Investment Advisers", a Discussion Paper of the Securities Commission of New Zealand (NZSC) issued in August 2001, expressed the concern that:

> "Often a significant portion of an investment adviser's remuneration is from commissions provided by issuers of investment products. To the extent that an individual is a self-interested and self-maximising unit, the incentive on an investment adviser to recommend the product that will bring him or her the highest commission is a relevant consideration. This economic interest may conflict directly with a client's interest in making an investment that results in the outcomes that he or she is looking for (for example higher returns or greater security or long term savings or readily accessible money)."[19]

Proposed Solutions

United Kingdom. In its Consultation Paper, "Reforming Polarisation: Making the market work for consumers," the FSA recommended that advisory firms wishing to describe themselves as "independent" would be limited to compensation by fee or a "defined payment agreement" with clients. Under a defined payment agreement, the client would pay a fee, but would be credited with any commission received from a third party with respect to the client's investments. The restriction would cover both the term "independent" and terms synonymous with it. In addition, the firm would be allowed to accept benefits from product providers only if directly relevant to the service provided to the client. An example of a prohibited benefit would be a sales convention in a deluxe location, where the cost of the information directly relevant to servicing the client was a small part of the costs of the event.[20]

As a result of constructive suggestions received from the industry, the FSA announced in October 2002 that it intends to propose a more flexible alternative to this approach. An independent adviser would still be entitled to receive commissions. However, the adviser would be required to offer clients a "menu" that included the option of paying by fee instead of by commission.[21]

The FSA also proposed in its Consultation Paper a requirement to provide in clear, understandable form at the point of sale unbundled information showing the cost of advice separately from the cost of the product. For products marketed directly without advice, the FSA expected to require that the cost of marketing be shown in place of the cost of advice.[22]

---

18 http://www.asic.gov.au/asic/asic_pub.nsf/byheadline/02%2F352+ASIC+releases+Ramsay+report+on+disclosure+of+fees+and+charges?openDocument pp. 13-14.

19 http://www.sec-com.govt.nz/publications/documents/law_reform/index.shtml p. 27.

20 http://www.fsa.gov.uk/pubs/cp/cp121.pdf pp. 52-54.

21 http://www.fsa.gov.uk/pubs/press/2002/103.html.

22 http://www.fsa.gov.uk/pubs/cp/cp121.pdf p. 70.

The UK currently deals with conflicts of interest arising from the sale of proprietary products through a "better than best" rule. Under that rule a product from a connected service provider may only be recommended if it would be more suitable than another generally available product. The restrictiveness of this rule, compared to the usual standard that a product may be recommended if it is not less suitable than other products, makes it very unattractive for fund management companies to have a significant ownership in an independent financial adviser. The FSA proposed to eliminate the better than best rule once conflicts were addressed by restricting independent financial advisers to compensation only by fee.[23]

The Sandler Report, published after the Consultation Paper, recommends that compensation for the provision of advice should be "subject of negotiation purely between the adviser and the consumer, with no provider involvement". Advisers would not be permitted to receive payment from product providers. Advisers could receive commissions contingent on a sale being made or determined as a percentage of the sale. However, variances in percentage fees depending on the type of product would have to be clearly justified. At the start of a relationship, and periodically afterwards, an adviser would have to give clients a fee schedule.[24]

The Sandler Report concluded that this arrangement would have two important benefits. First, it would make it much more difficult for there to be commission bias. Second, it:

> "would enable the development of a properly functioning market in advice. Consumers would be much more aware that they were purchasing advice, distinct from the product, at a cost. They would have clearer incentives to focus on the cost and quality of the advice they were receiving. In addition to improving consumer outcomes, this would benefit the better advisers. Currently, an adviser's level of commission is strongly influenced by his market power vis-à-vis the provider of the product. In the model proposed by the Review, it would be his ability to add value for the consumer that was the principal determinant of success."

The Sandler Report found the FSA's proposal in its Consultation Paper to be overly restrictive in not permitting the payment of commissions to independent advisers.[25]

The Sandler Report states that the FSA's proposal to tie its compensation restrictions to the use of a term such as "independent" is inadequate. It proposes that usage of the term "adviser" should be restricted in the same manner.[26]

The Sandler Report further recommends that the FSA publish tables showing, for each type of product, representative wholesale prices, where providers sell through independent advisers, and representative retail prices based on average commission levels.[27]

United States. The SEC Committee on Compensation Practices found that best practices were characterized in part by compensation policies designed to align the interests of the brokerage

---

23 Id. pp. 55-56.

24 http://www.hm-treasury.gov.uk/documents/financial_services/savings/fin_sav_sand.cfm, p. 188.

25 Id p. 189.

26 Id. p. 190.

27 Id. at 191.

firm, the individual adviser and the client as the three parties to the relationship, and to encourage that relationship to be long term. Best practices identified by the Committee relating to adviser compensation include the following:

1. Payment of identical commissions to advisers for proprietary and non-proprietary products within the same product type and for principal and agency transactions
2. Payment of compensation to advisers based at least in part on the amount of assets in an account. That way, advisers are not left uncompensated where the best advice is to do nothing or to use the funds in an account in a manner that does not pay commissions to advisers.
3. Not permitting sales contests or restricting contests to broad measures that do not favour particular products
4. Deferring a portion of adviser compensation for several years and linking payment to a clean compensation record
5. Using stock option or stock purchase plans as part of the compensation package for advisers
6. Linking adviser compensation to client satisfaction
7. Separating the adviser from the firm's economic interest in order flow, bid/ask spreads, and the sale of inventory. For example, where feasible, trading floors could be organized so that advisers are unaware of products held in inventory.
8. Establishing special procedures for the purchase of higher risk products, which typically would provide higher compensation to advisers. An example of this practice was a national firm that does not allow the purchase of penny stocks, limited partnerships and most derivatives unless the investor has completed an Investor Qualification Affidavit.
9. Paying inexperienced advisers a fixed salary that gradually transitions to performance-based pay over a two- to three-year training/mentoring period
10. Making special efforts to inform investors of their rights and responsibilities. One example is informing investors of alternative, fee-based compensation arrangements.

The Committee recognized that these best practices would not necessarily apply to all situations. Where potential conflicts between the investor and adviser remained, the Committee concluded that full disclosure of compensation practices can reduce the potential for conflict and abuse.[28]

In its report, the GAO recommended that the SEC require that periodic account statements provided to mutual fund investors include the dollar amount of each investor's share of the operating expenses paid by their funds. The GAO considered the failure to provide this information to be inconsistent with the typical approach of disclosing to consumers the actual dollar amount paid for financial services. The report also suggested that an increased awareness of the fees paid by fund investors could enhance fee-based competition.[29]

---

28 http://www.sec.gov/news/studies/bkrcomp.txt pp. 9-16.

29 http://www.gao.gov/new.items/gg00126.pdf pp. 66-72 & 96-97.

The GAO put forward three alternatives for the disclosure of investor fees in periodic reports. The preferred alternative from an informational viewpoint is a statement of the actual fees attributable to an investor's holdings. The drawback is that this would require fund management companies to keep detailed records on expenses incurred each day and apportion them among investors. A further complication occurs where fund management companies maintain an omnibus account for each dealer and it is only the dealers who maintain the individual account records. A broker with about 6.5 million customer accounts estimated the cost of developing the necessary systems might be as much as $4 million and annual costs could be an additional $5 million. For that broker, the initial and annual costs would each be less than $1 per investor. At the GAO's request, an industry research firm estimated that initial programming costs to mutual funds for providing quarterly personalized expense statements probably would cost less than a penny per investor.

In a customer survey conducted by a large broker, 89% of more than 500 respondents stated that knowing the specific dollar amount of fees paid on mutual fund investments each quarter would be useful, although 54% said that they were very unlikely to be willing to pay for this information.

A less expensive alternative put forward by the GAO is to approximate the fees attributable to an investor by multiplying an investor's average holding during a reporting period by a fund's management expense ratio (MER) for that period. This would allow an investor to receive dollar cost information in reports without the need to maintain more complex daily records for each investor.

A third alternative raised by the GAO is to provide cost data in reports based on an assumed investment amount such as $1,000. This alternative would provide information to investors that investors would then have to use as the basis for calculating approximate costs on their own.[30]

Following the GAO Report, the Division of Investment Management of the SEC published in December 2000 a "Report on Mutual Fund Fees and Expenses". The SEC Report considered the GAO's recommendation on a preliminary basis. Without yet carrying out a quantitative cost/benefit analysis, the SEC suggested that providing cost data based on an assumed investment amount was likely to have the most favourable trade-off between costs and benefits. The SEC noted the complexity of providing actual individualized data on reports, although it did not specifically address the alternative of approximating the personalized amounts by multiplying the average holding during the period by the MER for that period.[31]

SEC Chairman William Donaldson told a meeting of the SEC on December 17, 2003 that the SEC will consider a rule in February that would require mutual funds to disclose semi-annually the dollar amount of fees and expenses paid by investors in the funds.[32]

Donaldson told the same meeting that on January 14, 2004 the SEC will consider a new form of confirmation for mutual fund purchases. He said previously that this form will provide customers with quantified information about sales loads and other charges incurred at the time of

30 Id. pp. 77-81.

31 http://www.sec.gov/news/studies/feestudy.htm pp. 46-48.

32 http://www.sec.gov/news/speech/spch121703whd.htm.

purchase. It is also intended to highlight incentives that brokers have in recommending particular funds, including specific information regarding revenue sharing arrangements and differential compensation for the sale of proprietary funds.[33] The SEC has also directed the staff to consider how disclosure of quantified information about sales loads and other charges incurred by investors might be disclosed in a document available before the purchase is made.

As mentioned in "Other ways to tackle compensation biases" at page 5 of this appendix, ceilings exist in the United States on the amount of trailer fees and on the 12b-1 fee payable by a fund to cover the cost of financing the payment of commissions for sales made through back-end loads. The ceilings are based on subsection 36(b) of the Investment Company Act of 1940, which provides that the investment adviser of a registered mutual fund or other investment company has a deemed fiduciary duty with respect to the receipt of compensation for its services or of payments of a material nature.

As a result of the potential for conflicts between a fund management company and holders of a fund's securities in relation to 12b-1 fees, the SEC also has imposed other limitations in Rule 12b-1. The fees may be made only under a written 12b-1 plan that describes all material aspects of the financing of the back-end load commissions. The plan must be approved by a majority of the security holders and by a vote of the fund's disinterested directors. The plan must provide that it may be terminated at any time without penalty by a vote of the security holders or disinterested directors.[34]

Australia. Under recent legislative changes in Australia, an FSP who provides financial product advice to retail clients generally must deliver a Financial Services Guide (FSG). In relation to fees the FSG is required to disclose, in easy to understand language in one place, who will pay for the advice, in what circumstances payment will be made, how the amounts will be calculated, and to whom payments will be made. If an actual dollar amount is unknown, it must be described through ranges, comparisons, formulas or examples. The disclosure is required to include reimbursement of operating costs, such as administrative costs or marketing allowances.

An FSG must contain information about any associations or relationships between an FSP and a product provider that "might reasonably be expected to be capable of influencing" the FSP in providing advice. The FSP may not describe itself as independent in the FSG unless various requirements relating to remuneration, volume bonuses, gifts, benefits, restricted product lists, associations and relationships are satisfied.

In the case of personal advice, the investor must receive a Statement of Advice (SOA), which includes information about any remuneration, commissions or other benefits that "might reasonably be expected to be or have been capable of influencing" the FSP in providing the advice. The Australian Securities and Investments Commission (ASIC) takes the view that any benefit received by the FSP falls within this disclosure requirement, except (i) an hourly fee that does not depend on whether the investor acts on the advice or (ii) a commission rebated in full to

---

33 Speech by Paul Roye to the ICI 2003 Securities Law Developments Conference (Dec. 4, 2003), http://www.sec.gov/news/speech/spch120403pfr.htm.

34 Before enacting Rule 12b-1, in 1978 the SEC considered even more restrictive means to address the conflicts in relation to deferred sales charges, such as a requirement that fees paid to the fund management company be a fixed dollar amount rather than a percentage of assets. Colonial Group, Inc., (SEC 1986) '86-'87 CCH Dec. ¶ 78,335 n. 10.

the investor. An SOA is not required if the FSP and client so agree if the advice is execution-related telephone advice. Requirements applicable to an FSG relating to associations, relationships and independence also apply to the SOA.

An investor in Australia also must receive a Product Disclosure Statement (PDS) when personal advice is given recommending a particular financial product.[35] The Ramsay Report, which only addresses disclosure requirements, recommends separate disclosure of the fees paid to advisers in the PDS as well as the source for payment of those fees. For example, the PDS would state that the management fee paid by a mutual fund is the source of the trailer fee paid to advisers. Where a fee paid to an adviser may be discounted by the adviser or rebated to the investor, this would be disclosed. The report also recommends that the PDS draw attention to arrangements that may exist between a fund management company and advisers concerning any other payments that the management company might make to advisers. As a matter of best practices, the Ramsay Report suggests that the fee disclosure section should be adjacent to the section of the PDS disclosing returns.[36]

The Ramsay Report concurs with the United States GAO that disclosure about mutual fund fees should be contained in periodic reports. A key advantage of providing this information in periodic reports is that it can enable investors to ascertain more precisely the cost of the investment. Periodic reports also were considered to have the advantage of being more likely to be read than PDSs in being shorter and because an investor has a financial incentive to review the details on the value of an existing investment.

The Ramsay Report recommends that actual fees relating to an investment should be disclosed in periodic reports if this could be done and a cost/benefit analysis by ASIC shows that it is not too costly. Should this not be feasible, the Report recommends applying the GAO's alternative of providing dollar amounts on reports for predetermined investment amounts.[37]

New Zealand. In New Zealand an investment adviser must disclose certain matters before giving advice and certain matters only on request. The matters to be disclosed on request include the adviser's relationship with an issuer and any remuneration that is "reasonably likely to influence" the adviser in giving advice. The NZSC has recommended that, following the Australian requirements, the disclosure required to be provided on request should be made mandatory and provided by advisers to all clients. It also has recommended that the term "reasonably likely to influence" should be reconsidered in order to ensure that all material benefits are disclosed.[38]

---

35 Currently the FSG and PDS must be provided as separate documents, although ASIC has indicated a willingness to consider allowing them to be combined into one document. "Licensing: Financial product advisers – Conduct and disclosure" (December 2002) http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/Advice_conduct_disclosure_ppp.pdf/$file/Advice_conduct_disclosure_ppp.pdf p. 20.

36 http://www.asic.gov.au/asic/asic_pub.nsf/byheadline/02%2F352+ASIC+releases+Ramsay+report+on+disclosure+of+fees+and+charges?openDocument pp. 213-16.

37 Id. pp. 216-19.

38 http://www.sec-com.govt.nz/publications/documents/law_reform/index.shtml pp. 27-31.

Appendix G

Feedback from Fair Dealing Model Website

This Appendix sets out responses to the Fair Dealing Model website survey, and presents a selection of representative comments from the website, grouped by subject. Minor errors have been corrected in the comments and specific names have been removed, but the comments are otherwise unedited. The information presented covers the period from October 6, 2002 to December 31, 2003.

The comments we received, both positive and negative, considerably assisted our thinking in drafting the Concept Paper. We very much appreciate the fact that so many advisers and investors were willing to make detailed and thoughtful comments on the difficult issues that underlie the Fair Dealing Model. We have attempted to do them justice in this Appendix.

Introduction

The Fair Dealing Model website was developed to provide a practical demonstration of how the model's three principles and three relationship categories might interact in real life situations. Our aim was to stimulate comment from both investors and industry members. Through standardised survey questions, the website encouraged visitors to the site to comment directly on the problems identified, the issues raised, the Fair Dealing Model's approach to solutions, and sample transparency documents as they worked through the site. It also allowed them to provide general commentary on issues of concern to them.

This was not intended to be a statistical survey. It was intended as a way to solicit direct input from a larger group of stakeholders than would normally correspond with us on one of our policy initiatives. Respondents were self-selected and not screened. The answers to specific questions and other comments represent the opinions of those who chose to contribute to the website, but we are not suggesting they can necessarily be extrapolated to a broader group. However, among those who chose to respond, there is some clear clustering of views.

The survey's answers to specific questions and the written comments complement each other as they deal with much the same subject matter. We have organised both types of responses under subject headings. We have included all the survey responses, even where a question generated a relatively low number of responses. Where fewer than 10 answers were received to a survey question we have presented the results as raw figures rather than percentages.

We have edited the written answers for clerical errors and length, and to remove specific references that do not add to the sense of the comment, but we have endeavoured to present the sprit of the responses, both positive and negative. We have omitted comments that dealt with specific complaints, issues beyond the scope of the Fair Dealing Model, and comments that reflected common misconceptions about how the Model is intended to apply in practice that we have attempted to address in the Concept Paper.

Who Commented?

Website visitors were given an opportunity to provide background information about themselves. Three hundred and forty-seven did so. All but a few of these individuals also answered survey questions or provided written comments.

Employed in the Financial Services Industry

Adviser		License			Portfolio Manager/Analyst		Admin		Legal	Accountant
Financial Institution	Other	Mutual Funds	All Securities	Life Insurance	Financial Institution	Other	Compliance	Other		
71	115	123	53	138	15	21	35	29	15	14

As an Investor

Type of Account						Knowledge as investor		
Discount – No adviser	Have adviser			Discretionary	Don't know account type	Novice	Intermediate	Advanced
	Pay Fees	Pay Commission	Don't know					
45	32	55	14	15	10	31	52	15

What Was Said?

1. Problems with current system

Practical manifestations of five fundamental problems (investor knowledge level, compensation opacity, outdated regulatory structures, confusion in responsibilities, sales compensation biases in advice) defined by the Fair Dealing Model Committee, in the Industry Focus Groups and in our own research were formulated, in each case from the perspective of an investor and of an adviser. They were presented on the website for comment:

Adviser Statement	Investor Statement
So many of my clients rate themselves as conservative investors, then insist on trading hot tips from relatives and bulletin boards. And they don't even want to bother keeping their personal financial information up to date.	My RRSP is all I've got for my retirement. Now I'm so frightened about what's happening in the market. I can't figure out how I'm doing from my monthly portfolio statement. I hear a lot about risk, but I don't understand how it relates to my investments.
I have to keep my commissions up to please my boss, but I don't think I'm always taking the time to give my clients the very best advice. The call us financial advisers, but are we salespeople or professionals?	I just found out that my mutual find pays my adviser, with my money, five times as much to have my assets in their fund as I pay him for his advice. Is he working for them or me?
I need four different licenses from three different regulators who all make me do different things – just to carry on a simple advisory business! The paperwork is killing me!	I'm trying to choose a financial adviser but I find it almost impossible to compare costs and services.
The "know your client" form doesn't help me and doesn't help my clients. I'm not going to sell them speculative securities, but if they lose money on something I know they'll blame me. Who can really decide if the trade was suitable for them or not?	I can't believe I own so many high tech stocks that have taken a dive! I'm sure I mentioned to my broker that I was looking to buy a house in a few years, once I knew I wasn't being transferred again. Shouldn't she have realised that I didn't want my account to fall below $50,000 no matter what so I could afford the down payment?
Bad apples don't get punished. They make the President's Club, then they get caught, but they're back in business in no time. It makes people like me who are trying to do a good job feel like fools.	I can't understand why my broker advised me to pull my money out of an inflation-indexed pension fund with guaranteed benefits and buy stocks and bonds instead.

Screen: The Problems

Statement	Investors		Advisers	
	% Agree or Strongly Agree	*N*	% Agree or Strongly Agree	*n*
I have encountered one or more of the problems noted.	**95%**	*19*	**88%**	*109*
The problems described represent important issues for the industry.	**89%**	*19*	**92%**	*109*
Any resolution of these issues will require significant change in the way the industry is regulated.	**84%**	*19*	**70%**	*108*

This question had a comparatively high response rate, particularly from advisers. A majority of both advisers and investors were of the view that the problems presented were real and serious. A larger proportion of advisers than investors thought that regulatory change was required to solve them. In addition, comments on specific subjects throughout the site derived from the real life experiences of the respondents often echoed the statements presented here.

In the open-ended comments, concern was expressed by a number of commenters on:

- Excessive emphasis in the industry on sales, with inadequate service once the initial sale is made.
- Industry practices and regulatory requirements that are overly restrictive, including requirements that are excessively burdensome on smaller firms and barriers on clients moving accounts.
- Lack of emphasis on proficiency.

Selected Comments

> "I found the problems section to be a very good overview of existing issues present in advisor/client relationships. The principle of transparency is the essential principle in these relationships and mutual accountabilities. The presentation of the model is very accessible in every respect."

> "When clients lose trust in the advisor relationship it has more to do with the industry's structural problems. In my opinion the main structural problems are the hiring practices, educational requirements, compensation structures and conflicts of interest. All major brokerage firms love to hire people with strong sales backgrounds. They want people who can sell, sell, sell. . . . No requirement for a post secondary education, no meaningful supervised probationary period or commitment to annual continuing education. The problem is most advisors can not dedicate the time to education because they need their next commission cheque. The fact that most investment advisors are commission based naturally leads to biased advice. After 18 months on a training program almost all firms cut the investment adviser off any steady compensation and leave them 100% reliant on selling their client. If they don't transact they don't get paid. Naturally they will try to sell the highest commissioned product. The mutual fund industry didn't grow just out of the benefits of diversification. Maybe the fact that it was the highest commissioned product, the advisors didn't have to create portfolios, follow stocks, educate themselves and could blame someone else for lousy performance while

freeing up time to sell, sell, sell had something to do with it. . . While I believe your efforts to instil confidence in the financial community are well intended I feel there are more pressing issues to deal with than your focus on the client/advisor relationship. If you are going to change the rules I challenge you to take this 30 year opportunity to change the way the industry works."

"I'm an advisor at a bank owned firm. For some years I have witnessed, and become deeply concerned by, the steady deterioration of the freedom to practice independent thinking at [a SRO] firms due to an oppressive compliance regime. In response to an increasingly hostile regulatory environment, compliance and the investment bankers are making it impossible to deliver independent advice by systematically reducing the practical alternatives to bank-built fee intensive structured products. The present regulatory pre-disposition will I'm certain, ultimately bring about the extinction of the personal advice relationship, and not accomplish its goal of preventing abuses."

As an Assistant Investment Advisor - I strong agree that bad apples are not punished and do make the presidents club because they are big producers - it doesn't seem to matter how they go about reaching the goal of president's club as long as they are producing for the firm. I find this very frustrating. The other issue is - no matter how you advice your client the I.A. seems to always loose if the client is unhappy. - If the client wants to buy something and the I.A. advises against it - if the stock moves up - the client is unhappy and will sue -- and vice versa."

"I am particularly troubled by the fact that so-called "financial planners" who are really nothing more than mutual fund salesmen, will go all out to land a client. . . . The advisor seldom if ever contacts the client to discuss the mutual funds that are held, whether they still represent the appropriate mix (equities, fixed income, money market etc.) . . . Did most people hear from their mutual fund / "financial advisor"? No. They were too busy trying to bring in new clients, because that is how they get paid. Clearly, the compensation drives behaviour. Mutual fund sales people get paid much more to land a new client, than they do to look after an existing client."

"I have been an advisor for close to 20 years. I was amazed at the level of commission paid on Mutual Funds and the level of 'education' required to earn these commissions. I have always felt that there has been inadequate legislation for 'competency'. The industry pays more attention to productivity and not enough to quality and competency."

"The other issue here, is that there are too many companies and their representatives who are not informing clients of "all" of the information surrounding their financial decisions. With a quota system in place in many companies, how can the company advertise that they have financial advisors? The very nature of quotas constitutes a sales environment. Those agents who do not know what they are "really" selling and are selling the products anyway because of the very lucrative commissions they receive, especially with whole life and universal life policies, need to really assess whether or not they are in the business to help people get ahead, or whether or not they are helping themselves on the ignorance of others?"

"It is my opinion that the capital requirements for type II IDA Members is far too high. Investment Counsellors post $25,000 while we post $350,000 plus match any non qualifying assets dollar for dollar. Given all of our internal controls we should only be required to post the deductibles on insurance coverages. Such high barriers to entry diminish the quantity of independent Members."

“Increased regulation and compliance is meant to protect both the client and the advisor . . . but is creating more workload and downtime in our industry. What happened to accountability . . . it is each persons responsibility to make choices that are sound.”

“I totally agree with the comments regarding the fact that the top sales people who operate in the grey areas usually don't get punished . . . they are usually rewarded.

“Your demonstration sums up many of the problems but a majority of them occur in the existing OSC regulated framework. If they can not be corrected there than what chance do other areas have once a holistic approach is used. By concentrating on the whole rather than the parts the result may be to bring the same level of problems to a whole industry rather than just one area. The "sound bite" from the man who felt pressured by the boss to sell or the piece where those that do wrong make the "Pres. club" are perfect examples of what happens in firms structured in brokerage style. I am an independent broker that specializes in one very specific section of our industry. I report to no one that sets sales levels and do what is in the best interests of my clients. I feel that I can do so by maintaining my independence. Being made an employee like those in your videos illustrates the problems I will face. Our industry needs help. Full commission disclosure is one thing that may help, but the supervisory model of the past serves no one but the insurers, brokerage houses and banks.”

“SRO is an oxymoron. They don't work. Fair Dealing is a must. There are too many vagaries for investors and little seems to improve in the hands of [an SRO]. Good luck.”

“I believe the OSC should do what it can to protect the small investor while punishing those guilty of a crime. I would prefer issues settled out of court with fines when possible.”

“Rules have always been in place to protect the consumer. The problem is not the lack of rules but the lack of policing the industry. There are a few bad apples in every barrel and the rules are not going to change that. Clients need education. They also need clear cut guidelines as to what advisors do. There is a big difference between financial planners and brokers but your rules are set up as though we are all brokers. You also assume all clients are well educated with large portfolios. It is the little guy who is going to be hurt by all these rules. The average Joe who wants advice but is fee adverse is the one who is going to be the big loser.”

“The industry and the existing regulations are not the problem. We all realise that when there are downturns in the market, there will be problems with some clients.”

“In the "old" days I had a stockbroker. I never had any illusions about how risky trading stocks was. It was very risky and I used my play money and not my nest egg. Since then I have bought mutual funds because the market has become too complex for a guy like me to understand. I thought the professional money managers would do a lot better than they have. The problem I have now is that mutual funds cost too much to own for the returns they generate. I don't understand where the mutual find industry and the regulators expect us to go now that the truth be told.”

2. Reactions to the Fair Dealing Model Approach

Question screens solicited comments on visitors' impressions of the system before viewing the Fair Dealing Model demonstration, and their reactions after viewing the demonstration.

Screen: Your impressions of the current system prior to exploring the Fair Dealing Model

Statement	Investors		Advisers	
	% Agree or Strongly Agree	*n*	% Agree or Strongly Agree	*n*
I would do better as an investor if the advice and information I get were better regulated.	**75%**	*16*	**56%**	*45*
As an investor, I understand my adviser's responsibilities to me.	**73%**	*15*	**73%**	*40*
I know exactly how much the financial services I get are really costing me.	**50%**	*16*	**63%**	*41*
For Advisers: the current registration system adequately fits my business practice.	**-**	-	**52%**	*33*
For Investors: My monthly portfolio statement does not help me manage my investments.	**46%**	*39*	**-**	-

It is interesting to compare these responses to later responses after an overview of the Fair Dealing Model had been presented. A small majority of advisers and a significant majority of investors who responded thought improved regulation would help them manage their investments better. While 73% of investors and 73% of advisers thought they understood their adviser's responsibilities at this stage of the demonstration, it is still noteworthy that nearly 30% of the investors did not. Only 50% of investors who responded thought they knew what their financial services were costing them, compared to 63% of advisers. Thus, in each case, a significant proportion didn't. Only 52% of advisers thought that the current registration system fit their business practice. The answer suggests that a majority of the responding investors felt that their monthly portfolio statement did help them manage their investments; however, survey responses and comments elsewhere in the site suggest that typical monthly statements are not very helpful.

Screen: FDM Introduction – Your Thoughts So Far

Statement	Investors		Advisers	
	% Agree or Strongly Agree	*n*	% Agree or Strongly Agree	*n*
Fair Dealing is compelling to me as an approach to resolve the problems for both the industry and investors.	**94%**	*17*	**71%**	*52*
I feel the way the OSC has presented Fair Dealing and asked for my feedback allows me to play a more active role in regulatory reforms that affect me personally.	**94%**	*16*	**75%**	*52*
I feel OSC has presented a balanced view of industry and investor issues.	**94%**	*17*	**62%**	*52*

A majority of both advisers and investors reacted favourably to the Fair Dealing Model and the website presentation. The open-ended comments on the Fair Dealing Model were both positive and negative.

Selected Comments

> "I have been through the site twice, and as an advisor, welcome the depth and breadth of the changes. It's about time. Finally, a way to level the playing field. I can only hope that my dealership will be able to respond positively and proactively to begin embracing some of the changes before they become mandatory."

> "I believe your fair dealing model is theoretically very strong. However, I believe that in practice it will not have much effect. With advisory relationships, adequate transparency is not enough. I believe that trailer fees paid from Investment Management Companies to advisors selling their funds should be reduced, but more importantly, equal within categories . . . I do not believe that increasing transparency about the advisor's fees will make much of a difference because the advisor will find reasons to justify his or her bias."

> "Advisors only act in their clients best interest if they are intrinsically motivated to do so. They are not motivated to do so by a regulation, nor is any amount of regulation going to dissuade unscrupulous types from inflicting harm on investors, but the over regulation designed to prevent this will hurt every investor with excessive costs. With the regulatory environment as their trusty accomplice, the banks win again by driving the cost of compliance so high that nobody but them can afford to be in the business."

> "When I first entered the investment industry twenty years ago I was taught by seasoned pros. They had four rules: 1. I had to meet the client face-to-face. 2. I had to learn the clients' situation and needs. 3. I had to provide good advice and appropriate securities. 4. I had to get it right. The problems we see today are a consequence of an industry that departed from the basics. Powerful industry lobbies broke down the system in pursuit of fast money. The situation was compounded by a mania for mutual funds and the bubble in technology investing. Would it not be simpler to return to the basics instead of reinventing the industry?"

“The Fair Dealing Model has some very valid findings, however the remedy seems to be weak and somewhat radical. Points of Weakness: It is the only industry where professionals do not have to be educated in the profession prior to entering the work force - at least one year of college with certain courses being mandatory would be one way of weeding out those who are not serious about this profession. At present, the requirement is equivalent to someone calling themselves lawyers because they have passed law 101. The papers are suggesting that most of the problems have to be solved by the dealers and the clients. No doubt some dealers are the problem makers and not solvers and most clients do not want to work as "police" since they already have other careers. This should remain the work of the O.S.C. In closing, I agree that an incremental approach and leveraging the "best" of what is already being done is more practical and cost effective. More rules without enforcement is very much a lost of time and effort.”

“I believe the Fair Dealing model is a good approach, however until there are some fundamental changes in the industry Investor Protection will continue to be inadequate. There are widespread practices in the industry that disregard the rules and regulations and result in extreme investor loss. It does not matter what the rules are if there is no intent to follow them. There is a need for a regulator that is intent on providing consumer protection in a meaningful way. If there is a breakdown in moral code and a lack of ethics, what can be done? Already the industry is trying to deny its responsibility even when it is clear there is a fiduciary duty to clients. This is evidenced by court documents. To restore investor confidence the regulatory system must be reformed. SROs should not be relied upon for investor protection. Regulators composed largely of industry-mindset staff should also not be solely responsible for investor protection. While industry knowledge may be desirable it must be counter balanced with staff who have a sense of basic morals and ethics, and a sound knowledge of what is right and wrong. It seems many in the industry lack this basic sense and are motivated solely by the profit incentive.”

“Advisors and suppliers today need to move from a transactional mentality to a relational mentality with their clients. This context helps ensure that decisions are educated, not emotional. Advice is geared to common interest solutions - not fees or commissions - as the relationship over time should be mutually rewarding for the client and advisor and supplier.”

“‘I feel the current system works well and I see no reason to amend it. With more regulations and red tape their will be added costs that the consumer will have to pay. There enough rules in place to deal with problems if the regulatory body simply enforced those rules. As my father always said if it’s not broke don't fix it.”

“The realization that mutual funds are unable to deliver on expectations and that the cost of owing them in 80% of the cases is too high, is leaving advisors and investors wondering what to do next. I understand why Fair Dealing is looking to move the investor mentality away from a products mindset but this would appear to create a vacuum just at the wrong time. Personally. I resent paying adviser commissions for mutual funds because you are paying twice for investment vehicle selection advice. I would prefer if advisors had access to professional fund managers expertise and rolled this into the value they deliver to clients without requiring the client to buy a fund. Currently, advisors seem to know very little about stocks and the most knowledgeable in this area are working for funds. Perhaps with enough fund failures, the model will change to something more equitable and affordable for investors. Or, maybe the mutual fund industry will change the way it compensates itself to save the industry from widespread failure. How about lower MERs and a bonus on performance?"

"I don't have these problems as my advisor has diversified my investments between GICs, liquid money & funds. The funds are a long term investment which I was told would fluctuate. Although I wish they had not gone down so much they have gone down in the past and have recovered over time. My financial advisor keeps me informed and we have moved funds to generate capital losses for income tax purposes. I can't see how changing the relationship with my advisor will change how I, or the general public, invest. When the markets get hot again people will jump in no matter what their advisor suggests. The time to buy is when the markets are down and very few people are buying at this time. How will your proposals change human nature"

"A step in the right direction. I agree regulators have a lot of catching up to do. This seems to address all of the pertinent issues, and appears to be a win win solution. Thanks for taking the initiative to move our industry to a more professional stature"

"This overregulation seems absolutely ridiculous. You are increasing the fees paid by investors due to this overregulation...very sad."

"In the Advisory role, I would agree with this new system. We are trained in many aspects of financial and with years of education and experience, we are qualified as an acceptant or lawyer would be in their own respected fields. We are dealing with people's financial future and yet find consistently, licensed people with virtually no knowledge except a license and certainly very little experience advising people on such an important part of their lives. Based on this Fair Dealing Model, I would certainly agree with it. There may need more details to know for sure, but this does appear in the right direction."

"OSC should be dismantled completely and let the real free market take charge . . . I can do my own regulation without the help of the Marxist gov't."

3. Reactions to Specific Aspects of the Model

Comments were solicited on the way the Fair Dealing Model proposes to apply the principles "transparency", "clear allocation of responsibilities" and "conflicts managed to avoid self-serving outcomes" at the account, transaction and reporting stages of the Self-Managed, Advisory and Managed-For-You relationships.

3.1.1 Choosing Services and a Relationship

Survey questions related to forming client-adviser-firm relationships, account opening documentation and processes generally, as well as the sample interactive Fair Dealing Documents for the three relationships.

Screen: Self-Managed Relationships

Statement	Investors		Advisers	
	# Agree or Strongly Agree	# Disagree or Strongly Disagree	# Agree or Strongly Agree	# Disagree or Strongly Disagree
A self-managed service provider should not be accountable for a self-managed investor's market losses.	-	-	4/4	0/4
A service provider should be able to send all documentation and trade-related information, such as confirmations, to the self-managed client electronically.	-	-	4/4	0/4
I would be comfortable having to keep advisory and self-managed accounts at the same firm completely separate.	-	-	4/4	0/4
Investors should have to go through a self-evaluation of their aptitude for self-management before opening a self-managed account.	-	-	2/4	2/4
A service provider should monitor a self-managed investor's performance and warn them if the investor is losing substantial amounts of money, measured as a percentage of their portfolio holdings.	-	-	2/4	2/4

Screen: Advisory Relationship

Statement	Investors		Advisers	
	% Agree or Strongly Agree	*N*	% Agree or Strongly Agree	*n*
The new licensing model, as described by Jane, fits my preferred approach to investing/dealing with clients.	**-**	-	**85%**	*20*
There should be a common set of cross-sector proficiency examinations for all retail advisers.	**-**	-	**89%**	*16*
Both the adviser and the investor need to better understand their responsibilities in making investing decisions.	**-**	-	**89%**	*17*
Adviser: Most current statements of the investor's goals and risk performances don't help me assessing whether their trades are suitable for them.	**-**	-	**50%**	*14*
Clients should be able to give their advisers a limited direction to make trades that are consistent with their Fair Dealing agreement, without prior consultation.	**-**	-	**53%**	*17*

Screen: Advisory – Services Provided

Statement	Investors		Advisers	
	# Agree or Strongly Agree	# Disagree or Strongly Disagree	# Agree or Strongly Agree	# Disagree or Strongly Disagree
The adviser should be required to offer the lowest cost of comparable investment options (best execution), subject to performance considerations.	-	-	5/7	2/7
The adviser/firm should be responsible for screening third party research for bias and quality.	-	-	4/7	3/7
Adviser: Without a complete, regularly updated financial profile, I can't properly fulfill my responsibilities to advise my clients.	-	-	4/5	1/5

A significant proportion of responding advisers indicated that the Fair Dealing Model's approach to client relationships matched their preferred style of practice. There was also a high level of support for a single set of cross sector proficiency examinations for all those providing advice to retail investors, and for improved understanding of their relationships on the part of both advisers and clients. Half the responding advisers felt the information they had as to clients' goals and risk expectations didn't help assess an investment's suitability, and about half would like the ability to exercise discretion to make trades for clients, subject to restrictions in the Fair Dealing Document.

Concern was expressed in the open-ended comments with the proficiency standards met by some people in the industry and insufficient transparency about proficiency

Selected Comments

"One unified regulatory system and one license for all financial products (MF, SEG, Life etc., Mortgage) and same rules to all will solve a number of problems. Also, a basic minimum university degree should be a must. . . . A strict control on the use of designation MUST BE TOP PRIORITY if you people want to bring faith in the industry."

"I'm a Montreal based financial advisor licensed to sell mutual funds and insurance. I also have both CSI courses required to sell stocks and bonds but am not working for a stock broker. I find it strange that I'm not permitted to advise clients on purchases of passive investment vehicles (Units) through a discount broker because I am not backed by a brokerage firm. If I was able to do so, I could save my clients a fair amount of money every year on fees."

"Advisors should be required to function independently via their own corporation not as employees of firms that are both manufacturers and distributors. . . . Functioning under the current model as an employee compensated by one source presents a conflict. In order to function and be properly perceived to be independent and unbiased a financial advisor should function corporately so that the primary "master servant" relationship exists with their client(s) and not their employer. Any advisor that chooses to work as an employee of a firm should be required to disclose to the public that a conflict exists if the employer also manufactures its own investment products."

"At the moment the bar to enter the advisory industry is FAR too low."

"The advisers should have designations that are completely understandable by average investors. They should be graded like chickens or eggs. Grade "A" etc."

"System permits too many neophytes to masquerade as 'financial advisers' when they have no meaningful investment background i.e. former bank tellers & insurance salesmen who blindly peddle bank/insurance co. mutual funds, regardless of their pedestrian performance."

"It should be more difficult to become an adviser and there should be a better code of ethics. -How banks can insure any type of advisory relationship when advisors change position every 2 months!"

"This interview is what we do today"

"The challenge is setting appropriate expectations between the advisor and the client. We advocate that services for financial planning, goal setting, tax, retirement and estate planning are all services that are distinct and can stand on their own merit. The commission from the investments should be linked to the time required to manage those assets. It is important for regulators to understand that the commission earned from the typical account is not enough to provide the type of ideal service you are striving for in this new model."

"What about the investor who never returns phone calls or paperwork? As an advisor, I spend many evenings and weekends trying to contact investors who think the entire responsibility of the relationship rests with the advisor. I don't get paid for the time, yet I am responsible for updating the KYC, etc."

"I would prefer to be contacted for consent prior to any trades; however, if the trade is time-sensitive and I can't be reached then in the agreement I would have stated that under certain conditions certain trades can be made without my consultation."

3.1.2 Mutual Responsibilities and Managing Compliance

There were relatively few responses to survey questions relating to the investor's responsibilities to the adviser, and the adviser's responsibilities to the investor. However the issues raised in the survey questions were addressed by a number of people providing open-ended comments.

Screen: Advisory – Rights and Responsibilities

Statement	Investors		Advisers	
	# Agree or Strongly Agree	# Disagree or Strongly Disagree	# Agree or Strongly Agree	# Disagree or Strongly Disagree
None of the information provided by the investor to the adviser should be used to support other business activities of the adviser's firm.	-	-	3/4	1/4
The adviser should only be held accountable for the advice given to clients to the extent that the client had disclosed relevant personal information.	-	-	4/4	0/4
The adviser should be required to ensure that the investor understands the securities recommended.	-	-	2/4	2/4
The investor should share in the responsibilities as described by Jane.	-	-	4/4	0/4
Permitting compliance and back-office functions to be contracted out to a third party provider like Compliance Inc. would be more efficient than the supervisory options now available to small multi-licensed advisers.	-	-	0/3	3/3

Despite the fact that none of the three responses to the survey's suggestion of contracting out compliance and back office services were favourable, there was considerable criticism in the written comments of the dealer-based supervisory model. Several advisers favoured an independent contractor model for advisers rather than an employee model as a way of reducing conflicts of interest. Concern was expressed about the negative effects of firm practices and culture within service providers.

Selected Comments

"I teach ethical awareness to professionals in the financial services industry. I have lots of comments from an ethical point of view (which is at the very basis of this OSC proposal) but I want to ask just one question for now. In the advisory and managed for you categories, a great deal of knowledge about the client must be known by the advisor in this model. However, most advisors, to meet the revenue demand of their firms, carry an average of 200-300 clients - how can any advisor have an in depth knowledge of so many people? You are, in my opinion, asking more than your average person could reasonably accomplish. I have read research reports which state that the most individuals any one person can "know well" is about 20 - 30. The number of clients required by an advisor to stay in business with most firms definitely works against this central proposal."

"I am concerned that the amount of time to invested by the advisor may result in smaller clients being left behind."

"Central problem arises from conflicted advisors paid by way of commissions. They are working for the product provider, not the investor. Are investors willing to pay the actual cost of independent advice? If not, can advisors become independent from product providers, permitted to sell any product they feel is best for their client? Could the relationship between the three parties be remodelled on that of an independent insurance broker?"

"I am an independent broker that specialises in one very specific section of our industry. I report to no one that sets sales levels and do what is in the best interests of my clients. I feel that I can do so by maintaining my independence. Being made an employee like those in your videos illustrates that problems I will face. Our industry needs help. Full commission disclosure is one thing that may help, but the supervisory model of the past serves no one but the insurers, brokerage houses and banks."

"I really feel that a major issue that has not been addressed here is the fact that there are many, many people in this industry who are moving products and creating transactions that are not necessarily in the best interest of clients. This I believe is happening for two reasons. One, there are a lot of people who have no idea how the products or services they are recommending actually work. And two, some of the companies that sell financial products (particularly Life Insurance products) seem to do their level best (through their representatives) to not inform a client of the real mechanics (including the downside) of a product or strategy they are recommending. Because there is a lot of money to be made by those of us who are licensed to help people with their financial decisions, I believe that a fundamental cornerstone of a transaction must be: Is the advice that I am providing this client, and the products and strategies that I am recommending in the best interest in the short and long term, or am I simply moving a product because both my company (quota system) and I (through commissions or fees) are going to be the significant beneficiaries of this and subsequent transactions? I feel this form, if used properly, will force representatives and companies to be held more accountable for their recommendations as long as the principles behind it are not spun through a marketing strategy, and as long as advisors understand that this document is not a marketing tool, and that it should never replace integrity, principle centred decision making, and an intellectual framework for both the investor and the advisor to make investment choices."

"After "to thy own self be true", the first and most important relationship a financial advisor must foster, respect and attend to, is his/her relationship her clients.

Unfortunately in Canada today, the regulations and systems in place often put the advisor into positions that compromise this relationship: 1. Employers, dealers or product suppliers demand production quotas. In some cases the dealers want “all gain . . . but don’t train”. 2. Dealer’s analysts and spokesmen provide recommendations that are unfounded or self-serving, with no acceptance of responsibility or liability. Example’s: 1. [a dealer’s] Bre-X recommendations and the assertion that advisors were at fault for inappropriately recommending Bre-X to clients; 2. [Mutual fund management company’s] wholesalers promoted to advisors, {Mutual Fund] as providing 5 different management styles that would buffer market swings; instead the managers concentrated their stock picks in High Tech at the market peak 3. Recently, [an investment pundit’s] promotion of [an issuer] and [an issuer] to clients of [a dealer’s] advisors (i.e. [a dealer] – a dealer/advisor”employer” [the investment pundit] has an interest in) is being argued by his lawyer as “education” and not advice. Meanwhile, its advisors that must pick up the pieces and answer to their clients for misleading information provided by others in the system. Client/advisor relationships in Canada need alternatives that give advisors more control in “putting their clients first”. For example: Mutual Fund Advisors should be permitted to: A. “bulk transfer” client accounts from one dealer to another. This is would help remedy situations where an Advisor’s reputation is inadvertently and vicariously impugned by their dealer’s malfeasance B. deal with (multiple) dealers who complete for advisor’s business based provided knowledge and expertise, training and development and good service. C. If independent, (i.e. in business for themselves, covering their own development costs and expenses) experienced and "educationed" (designated) advisors should be permitted to deal directly, without nominee accounts, with product manufacturers and not be required to kow-tow to a dealer. If necessary they may choose to engage a “compliance” or “external auditor” services to review and certify their business practices. In the p&c insurance business, companies engage “auditors” to review insurance practices and if irregularities are found, it’s reported to the company and the regulator. Please give those who “put client’s first” a stronger base of operation.”

“. . . the real crime in this industry today is the exit fees the big bank dealers charge clients to keep and close accounts. If a client is unhappy with their situation, to some extent they face substantial costs to close their accounts. The client should not be placed in this situation. They should have freedom to move at any time for any reason.”

3.2 The Fair Dealing Document

The specific questions on the Fair Dealing Document, accessed from several parts of the website, generated a positive reaction to the proposed content of the Fair Dealing Document, but a mixed reaction to the actual sample shown. There was particularly strong adviser support for the way the sample Fair Dealing Document outlined and documented responsibilities and from investors for its presentation of services and service level. The relatively small number of advisers and investors who answered from a discretionary management perspective were generally positive on these points as well. A majority of advisers agreed that the sample Fair Dealing Document presented on the website was too long and hard to understand. There was small but negative response to the sample's treatment of risk tolerance.

Screen: Managed-For-You Relationship

Statement	Investors		Advisers	
	# Agree or Strongly Agree	# Disagree or Strongly Disagree	# Agree or Strongly Agree	# Disagree or Strongly Disagree
The Fair Dealing Document adequately outlines the responsibilities and expectations in a "managed-for-you," or discretionary, relationship,	2/3	1/3	2/3	1/3
The Fair Dealing Document adequately explains how my portfolio manager uses research and deals adequately with possible conflicts of interest.	½	1/2	2/3	1/3

Screen: Fair Dealing Document, Interactive Fair Dealing Document

Statement	Investors		Advisers	
	# Agree or Strongly Agree	*# Disagree or Strongly Disagree*	% Agree or Strongly Agree	*n*
I would find it helpful to have my responsibilities and those of my service provider laid out as in the Fair Dealing Document.	7/11	4/11	**80%**	*15*
I feel that the Fair Dealing document would help me better understand what my adviser's services are and what service level he/she committed to.	8/10	2/10	**60%**	*15*
I am capable of giving meaningful answers to the questions about my risk preferences in the Fair Dealing Document	2/3	1/3	**43%**	*14*
The Fair Dealing Document is too long and hard to understand.	1/3	2/3	**77%**	*13*

Open-ended responses recognised the value of defining the relationship between the service provider and the investor more clearly at the outset. Comments on whether the sample Fair Dealing Document shown on the website would be helpful or would just entail unnecessary additional effort were mixed. Some advisers were of the view that the clients would not be able to understand the information, and explaining it to them would require too much effort on the part of the adviser. It was proposed that simpler documentation should be permitted for younger investors with smaller accounts. Several industry participants commented that the amount of adviser attention to the client that an Advisory relationship under the Fair Dealing Model entails would not be compatible with the revenue generated for small accounts.

Selected Comments

> "The premise of fair dealing, establishing a clear relationship track, roles & responsibilities is important. Like an Investment policy statement, this agreement should level set expectations on both sides. I congratulate the committee for not falling into the trap of becoming too granular in their definitions. Maintaining high level definitions should minimise the potential for relationship migration."

> "I like the idea of a better-defined relationship with your adviser. So far my trial and error approach has produced mostly errors. I think advisers are primarily salespeople trying to act like advisers. I would rather they were more honest about how much money they need to make from me and than we can past some of the games."

> "I operate in an advisory relationship with most of my clients. I only sell Mutual funds and Ins. I have a very large client base with about 60% of my book of business in GIC's. Some of my clients in the M/F side have small account balances. Many advisors would not deal with them. My concern with adding a layer of administration [is] that my clients will not understand. I fully disclose all fees and how I am compensated. If I had to enter a fee arrangement with each client and implement the Fair dealing model as it now stands the losers will be the investors. I would seriously consider a self managed relationship which will put my clients at a loss. I will be more concerned about potential litigation than what is best for the client. The investment climate is changing. Much more understanding is needed of the FDM. I also believe the KYC form now used is outdated and does not help the client. I have started to use a investor policy statement with my clients. Let's not put something in place where one fit applies to everyone."

> "The vignette illustrates situations that exist between advisor and investors. From my experience, many of these problems are rooted in lack of consistent sales process, which include but are not limited to Advisors not obtaining enough of a complete picture of the client's current financial situation while in other cases clients keeping their holdings, "close to the vest". The latter can be uncovered through an advisors strong constitution and commitment to a consistent sales process and factfinder. The distinct need for each firm to support a common sales process, and factfinder including risk profile is the first step towards mitigating the aforementioned statements."

> "I believe strongly in full disclosure and obtaining complete facts before proceeding on the client's behalf, however, the type of imposed questions required on the new know your client form format is just a cover yourself type of protection for the advisor without offering the clients any better understanding of their circumstances."

"For more investors, the detail provided in this sample document is much more than most can comprehend. As a result, the investor will likely end up purchasing GIC's, which may not help them to their goal, or working in a self-managed situation, which may result in disaster. The thoroughness and the complexity of the document should not be a detriment to the process. In our practice we are working on a document that would contain the following: a) A basic KYC that bridges into a risk tolerance questionnaire. The result of the questionnaire produces a one page Client/Investment Profile. The profile includes information on the sensitivity analysis of the sample asset mix (that came from the resulting questionnaire). We are then planning on including a document that states our basic level of service (1 statement per year from the dealer, semi-annual statements from the fund company, on-line newsletters, no pre-arranged annual reviews). In most cases, clients with less than $100,000 are either many years away from retirement, or the amount of money is small and not a major part of their overall situation...thus, a review is required on only a periodic basis. We came to this conclusion when we began to ask the client how often they expected us to review the portfolio and how often they wanted to get together. Most people responded: review the plan quarterly (handled internally), and let's get together only when required. b) An enhanced services document: for clients with $100,000 to $400,000 in assets showing them all of the planning services available. Most of these services would be paid for by the client writing a cheque. c) For clients greater than $400,000, the client selects the services they desire, we determine the cost for the service and then set the MER accordingly by adding the appropriate basis points on top of the management fee to cover our costs. Personally, I feel the Fair Dealing Document is way too much for most investors under age 40 and with less than $250,000 in assets."

"Doesn't provide nearly enough information if you are opening a futures account. If the idea is to have only one document, then greater detail is a must."

"The "Fair Dealing Document" doesn't ask the following: 1. What is the client's insider status? 2. Who, other than the client, has an ownership interest in the account? 3. Doesn't ask for info pertaining to the client's spouse. 4. Doesn't ask how the client came to do business with the firm. There are several other "KYC" related questions which are not currently part of the Fair Dealing Document. It would be very helpful if these issues and/or questions were to be included in the document so that a client need only complete and sign one package rather than a multitude of forms."

"This Fair Dealing Document is far to detailed and complicated. The client does not need the amount of information that you are trying to provide (I must say in a very biased format), they want it simpler. The more data you present, the less they are going to listen. Having to provide the level of disclosure that you are suggesting goes far beyond what is required in any other industry. Please do not kill our industry. Yes, there are disclosure issues that need to be addressed, but this is major overkill."

"How do you deal with the client who is already busy and get him or her to sit down for an hour to an hour and a half when all they want to do is deposit their RRSP contribution and go?"

"The time to complete the web information on this type of relationship was lengthy and arduous and I really wonder how many people would be willing to take the time to do it. If they were at the advisors office they would at least be required to read and execute the document but then based on all of the other comments on this OSC web site how will the advisor be able to say that client read and understood the document? Should the advisor insist that the investor go to their solicitor to get Independent Legal Advice before executing these documents? Basically people have to take some responsibility for their own actions. They are given the information, told that there are no guarantees, etc. If the markets go up the investor is happy but if they go down the investor is upset. The investor can change advisors at any time which gives them the flexibility to make any changes they deem necessary"

"Web availability for what reason. A number of investors don't have access or use the web. Mature clients find it difficult to navigate & often don't have access as it's too complicated. Those investors that are well to do financially don't have the time to go onto the web - there too busy in their own lives."

"I think I would need more knowledge of risk and maybe some tools to play with difference risk scenarios in order to complete the risk part of the Fair Dealing document"

"While I feel strongly that a process such as this is very positive I believe strongly that it will quickly lead to; fewer advisors for as they will no longer be able to afford to stay in business considering all the additional time this will require, lower service levels for low net worth clients because advisors will simply not take them for the level of comission that would be equitable for both parties, all of this leading to an ultimate geater divide once again between the haves and the I don't have that much yet."

"I agree that there are issues in the securities industry. I have some concerns, however, about turning more and more of the processes into a commodity with increasingly overburdening regulation. Setting minimum standards, and providing consumer education might be a better approach. A lot of the info in the Fair Dealing Document is important, but should be presented by the advisor in a format that best suits the relationship. Even physicians aren't required to disclose medication info in such a format."

"This new model will create a mountain of new paper work and fees for the average advisor that will force many good advisors out of the business. The average client simply buying mutual funds will not get much benefit out of all these new requirements. In a world of over regulation, the only loser in all of this will be the small investor and the advisor just starting out. Advisors will be forced to start raising minimum account sizes or charging more fees to theses accounts, to help offset the additional resources required to comply with this model. Instead of punishing all advisors and investors (because even large investors will pay more for the added work, why not put the emphasis on going after the advisors actually creating all the problems. I do agree that the industry was a bit slack about 10 years ago but going from one extreme to the other is very irresponsible, especially at our expense. The only thing this model will accomplish will be to eliminate the smaller companies and the rights of small account holders in favour of bigger accounts and companies. How will that help anyone?"

"This is truly a waste of taxpayer dollars. You are adding more layers of confusing paperwork and documentation to an already document filled area. What were you thinking?"

"I like the thoroughness, so that the client is covered in all areas of the introduction & process of the relationship"

“I am pleased to see, finally, the recognition of a document(s) that outline more than "simple details" of the client and the relationship with their "advisor(s)"… interacting numbers with specific questions challenging the client to disclose important discussions of THEIR perceived expectations and the ability of this advisor to achieve it”

“Basically the clients deal with people they trust and have confidence in. An advisor does not get into this position without devoting a great deal of time and effort to learn about investment alternatives that a client can chose from given their own specific situation. One component you mention in your presentation is that the onus is on the advisor to ensure that the client understands and READS forms they sign. How do you prove that this actually happened at the time the forms were executed? In addition how do we as advisors determine that the client has indeed read the forms? Perhaps we will be required to read the form to clients like a parent would read to their child which is obviously ridiculous. It appears to me that this is a set-up for people to have an out to sue an advisor should something go wrong with their investment even if the advisor took all the time to explain the investments to the client at the outset. When one goes to see their lawyer, accountant, doctor, etc. they do not necessarily understand everything they are being told or that they are signing. The client has confidence in the party they are dealing with and as such they sign the paperwork as required. If some advisor is going to defraud people he may or may not use the forms you propose or he may not properly explain them to his clients. How is this going to help clients? If someone is going to cheat people they will find a way to achieve this end. Basically you appear to be endeavouring to put into place new rules and regulations which will only increase paperwork and create time consuming tasks.”

“I'm not sure you can regulate the age-old problems of greed and fear, except the pension industry model of an asset allocation with downside risk and expected long term return and an Investment Policy statement type of approach.”

3.3 Conflicts and Compensation

Transparency as an essential ingredient of properly managed conflicts of interest is a central theme of the Fair Dealing Model. The tendency of sales-based compensation systems to influence financial advice is a key regulatory concern. Survey questions related to possible solutions.

Screens: Advisory – Negotiating Fees and Managing Conflicts

Statement	Investors		Advisers	
	% Agree or Strongly Agree	*n*	% Agree or Strongly Agree	*n*
The amount and approach to fees paid should be negotiated between the adviser and the client.	**-**	-	**90%**	*10*
Payments by issuers like fund managers to advisers conflict with the investor's best interests.	**-**	-	**30%**	*10*
If the adviser is guaranteed a minimum annual fee, the quality of advice will improve.	**-**	-	**60%**	*10*
All compensation received by the adviser related to an investor's portfolio should be disclosed to the investor.	**-**	-	**60%**	*10*

Screen: Managed-For-You Relationship

Statement	Investors		Advisers	
	# Agree or Strongly Agree	# Disagree or Strongly Disagree	# Agree or Strongly Agree	# Disagree or Strongly Disagree
My portfolio manager should not earn income from third parties. His/her only source of income should be the fees that I pay.	2/3	1/3	2/3	1/3
It should be possible for a portfolio manager's fee, in part, to be based on the performance of the portfolio, measured to an agreed upon standard.	3/3	0/3	2/3	1/3

Screen: Self-Managed Transactions

Statement	Investors		Advisers	
	# Agree or Strongly Agree	*# Disagree or Strongly Disagree*	% Agree or Strongly Agree	*n*
Service providers should report all sources of compensation connected with investments and transactions by a "self-managed" client.	1/1	0/1	**78%**	*46*

Within the somewhat limited response to specific survey questions on compensation structures, there was strong adviser support for the amount and method of adviser compensation to be negotiated by the client and adviser. A slight majority of advisers agreed all compensation received by an adviser relating to an investor's portfolio should be disclosed. The relatively small number of adviser and investor survey responses from a discretionary management perspective indicated a preference for fee-based compensation tied to the client's portfolio's performance. In contrast there was a high response and a significant majority in favour of all sources of compensation being disclosed to self-managed investors.

In the open-ended comments, there was a general concern on the part of advisers and investors about the biases and pressures introduced into advice by sales-based compensation systems, but there was no clear consensus as to how to avoid them. One respondent acknowledged that their firm's product recommendations are set to ensure an appropriate revenue level on an account. Concern was expressed that if fees were service based and transparent, investors might not be willing or able to pay them.

Selected Comments

> "Working on my 10th year in the industry (5 of them as a broker), I have always maintained that until we change the compensation structure of the retail broker to better align it with the interests of the investor the problems that you have accurately uncovered will never be eliminated entirely."

> "The challenge is setting appropriate expectations between the advisor and the client. We advocate that services for financial planning, goal setting, tax, retirement and estate planning are all services that are distinct and can stand on their own merit. The commission from the investments should be linked to the time required to manage those assets. It is important for regulators to understand that the commission earned from the typical account is not enough to provide the type of ideal service you are striving for in this new model."

> "I'd like to see OSC come up with a policy which basically says: if investor is making money, the x% fee is fine. If investor is losing money, a proportional portion, say y%, of the fee should be re-directed back to the investor. This is the only way to make advisor accountable and the only way to truly share responsibilities between advisor and investor as you stated in your OSC website."

“I like the idea of a better-defined relationship with your adviser. So far my trial and error approach has produced mostly errors. I think advisers are primarily salespeople trying to act like advisers. I would rather they were more honest about how much money they need to make from me and than we can past some of the games.”

“I have personally had experiance with non disclosure of fees associated with the purchase of mutual funds, specifically concerning trustee and transfer fees. I have also found that the disclosure (vague as it is) of front load or back load fees, usually takes place only if the investor brings the subject up. In my opinion full written transparency of fees by the advisor is a must not an option, anything less will not achieve fair dealings.”

“With the rise of "fee" accounts, this old argument doesn't work any more, because the advisor has no incentive to churn. so the first thing is to make sure, as you have, that a discretionary "managed for you" account is managed strictly on a fee basis. This solves the deepest conflict of interest.”

“Equity commissions are much higher than fixed income commissions, and so we have had generations of clients who have had accounts with lopsided asset allocations, often 100% equity and 0% fixed income. Of course, it's inappropriate for many clients.”

“I have recently interviewed over 14 brokerage firms who payed lip-service to fee-based accounts. The reality is that head-office executives know that this is the best sustainable business model, but branch managers are rated on how productive their IA's are in the short-term. This creates a complete conflict of interest for the IA who preaches long-term management principles to their clients, yet must respond to short-term production goals.”

“Transparent fee schedule, specifically for the full service brokerage industry, is a move in right direction. Most Clients have little knowledge as to how much they are paying each year and thus can not accurately assess "value added". Value added being defined as the relationship between quality and price.”

“I feel that some financial advisors are forced by their bosses to spend less time with their clients because they are not making money. It is the simple rule of time is money. Do you want quality or do you want quantity.”

“The financial institution I work for uses a commission grid. These grids which are based on ticket size and claw backs because of discounts are a conflict of interest. They also encourage churning.”

“The need to generate specific set revenue is an obvious concern. The need to align the interests of the firm as well as those of the advisor will help to align the interests of the advisor with those of the investor.”

“It would be nice to have 300 clients at $400,000+ in assets, but this is not a reality for the majority of the industry. So there lies the disconnect . . . the challenge for the advisor to be paid what they are worth, to earn a decent income to support their family, to provide excellent guidance . . . for the average investor with typically $100,000 or less. It cannot be done without something giving in. Typically, the advisor then tends to work extremely long hours on weeknights and weekends, or service needs to be reduced to the client (i.e.: expectations need to be clarified), or the client pays a fee for the financial advice they receive. In our practice we are embarking on the following strategy: a) We feel we need to earn $4000 per year to provide comprehensive service. We feel we need to earn $1500 per year for basic service. b) The trailing commission, and the product recommendation, is thus based on the revenue that needs to be generated. c) Example: For accounts under $100,000 . . . all assets are sold on a DSC basis. Other services for retirement planning advice and modelling, for example, we have to charge an hourly fee. d) Example: For accounts between $100,000 and $400,000 some combination of DSC, low load and 0% front end load. In this situation we would charge a reduced rate on services. e) Example: For accounts greater than $400,000 we are recommending products whereby we can adjust the trailer fee to be paid what we need to be paid and not more. This gives a break to the high end client because their MERs will be less under this scenario than one whereby the trailer fee is fixed at 1% for example."

"As a RR I am legally required to have my license with a registered financial institution, but they abuse this privilege since I am really nothing more than a profit centre to them. Take the fox out of the hen house and have the advisor establish a direct client relationship with no one else in the middle taking a cut. While no one wants to face up to it, any good advisor can easily improve returns to the client simply by stripping out transaction costs and mgt fees. This would leave money on the table for the client to pay the advisor with money left over that would remain in the client's accounts. You could establish a regulatory category that provides for this type of advisor - client relationship. If the client had a complaint then they should have clear access to a complaint procedure and a broker who abuses this relationship should be dealt with."

"I believe the issue about fee disclosure only becomes relevant on larger accounts of $500,000+, for example. Up to that stage, smaller investors today will typically not be able to afford the typical cost of managing a portfolio. We estimate the cost of managing a typical portfolio ranges between $1000 and $1500 per year (when you factor in the time spent with the client, administration time, statements, newsletters, value added seminars and mailings, etc). Therefore: Should all fees paid be negotiated between the advisor and the client? I disagree because in most situations this discussion is irrelevant unless the client is interested in writing a cheque for $1000 or more each for the same advice they are getting today, paid by the DSC commissions. Payments by issuers to advisors conflict with the investors best interests? Absolutely not! To ensure the investor is properly taken care of . . . you should first ensure that the advisor is paid fairly! Question #3: As above. Yes, a minimum annual fee of $500 to $1000 for all accounts is critical for the advisor to do their job. Question: All compensation received should be disclosed? This sounds like a make work project where the advisor needs to track and report this information. Rather, this should be a basis of competitive advantage between advisor firms. If the advisor wishes to disclose, and it serves them well, then goodie for that advisor. If another advisor wishes not to disclose, and the client doesn't like it, then the client can leave . . . Negotiating fees only becomes relevant on larger accounts. The vast majority of clients are being subsidized by the higher fees collected from the larger accounts. If the larger accounts negotiate appropriate fees downward, then the smaller accounts need to start paying their own way. I expect that most of the smaller account holders (i.e.: $250,000 and less) will not be happy with this and will also not be able to afford the advice they require. In our practice we are beginning to disclose and negotiate fees for our larger accounts of $400,000+. However, we are doing it by limiting the initial services to the smaller accounts and charging fees for advice as required. Not all clients like this approach."

“I believe the client should still be given the option of choosing the current fee structure. With respect to conflicts of interest - I understand the argument made, but the VAST majority of people in the industry are honest, upstanding people who DO put the interests of their clients before their own. While ANY profession has its bad apples, the regulators should be very careful not to paint the entire profession with the same bad brush. Some of the policies that result from this approach could (in the long term) end up hurting the investing public more than it helps them. My advice is that the OSC spend sometime with the independent advisor community to see the potential implications before going on with the Fair Dealing Model. While some of the proposals in the FDM are good, other parts of it can have disastrous effects on the industry (i.e. effects on E&O insurance premiums, compliance costs and the resulting effects it has on reducing competition etc.).”

“Advisors should only profit when the client does with the amount negotiable within a controlled range to reflect the degree of independence required by the client. There should be a formal signed contract to this effect. Commissions paid by an issuer should be split between client and advisor according to this ratio. For services (record maintenance, statement preparation, purchase and sale of assets, etc,) there should be a fixed fee schedule related to the amount of time and responsibility involved, and approved by the O.S.C. In essence advisors, funds, and institutions should not be earning while losing money for their clients.”

“Stop talking about fees and compensation all the time. Start talking about the level of research, education, CE credits and professional services. After all, we are a business and not a library!”

3.4 Investor Information and Decision-Making

3.4.1 Investor Education

The Fair Dealing Model makes a number of proposals for achieving transparency in important matters. One of these is to support an enhanced educational role for firms and their representatives.

Screen: Securities Information Sheets

Statement	Investors		Advisers	
	# Agree or Strongly Agree	# Disagree or Strongly Disagree	# Agree or Strongly Agree	# Disagree or Strongly Disagree
As an investor, I would find the package of securities Information Sheets helpful.	8/10	2/10	-	-
As an adviser, the package of Securities Information Sheets would help me educate my clients about important issues.	-	-	8/8	0/8
Reading the Securities Information Sheets has improved my knowledge of the types and significance of risk.	-	-	5/7	4/7
Reading the Bond Information Sheet, I have a better understanding of the costs involved in buying bonds.	-	-	6/8	2/8
Reading the Equity and Mutual Fund Information Sheets has improved my understanding of how equity trading and pooled portfolio management works.	-	-	6/8	2/8

It interesting to note that almost as many advisers as investors responded to questions about the Information Sheets, and most of the adviser respondents indicated that they found them instructive.

Open-ended comments reflected concerns with voluminous disclosure material that does not achieve transparency both under the existing rules and if called for by the Fair Dealing Model. Some favoured the sample Information Sheets or CD-ROM equivalent, but others were sceptical as to investors' willingness or ability to participate in an education process with their advisers. Some commenters suggested that the firms should not be involved in preparing the content of the Information Sheets. Comments also were received on content. There was a suggestion of using a dialogue approach rather than written materials to make the Information Sheets more accessible.

Selected Comments

> "I also spend a lot of time explaining the basics of investing - what a mutual fund is (you would be surprised how many people have been investing for years and they still can't explain what a mutual fund is), risks associated with growth and value funds, and markets in general. So I like what I see here with one exception. It leads to more paperwork and it overloads the investors. Eight years ago I would complete a two page KYC (one page front and back) and give the client a 50 page

prospectus on the fund(s) that they were buying and I would still explain the basics above and discuss alternatives. Now they sign 4 different documents in order to open an account, total page count is 10 pages and then I hand them a 310 [page] prospectus. This is over and above a couple of marketing pieces I give to clients (which review the basics I have already told them about). If I split their money up in 2-3 companies they get 1 or 2 more prospectuses and 2-3 investment apps as well. Then we wonder why investors don't read the prospectuses and all of the fine print. Investors are overwhelmed by too much info (most of which is useless) and by adding more info to the pile, most investors will read even less and they will understand even less. Some advisors seem to like this, since an investor who throws up their hands in frustration, can more easily be taken advantage of because they don't understand. Mutual funds aren't that complicated. We need to condense the information and focus on the important parts in simple, straight to the point and easy to read information. And the OSC should be encouraging investors to read that information. For those advisors who don't explain the risks adequately or give inappropriate advice the OSC should make it easier for an investor to make a complaint and the OSC should throw the book at those advisors."

"I like the documents shown for examples. Could a very comprehensive glossary of investment terms also be included? This would incorporate both industry terms (ex. MER) and terms professional often use (ex. comprehensive overview). Unfortunately, not all clients are as familiar with standard business terms as a FP may be."

"Why TSE restricts details of market Depth? If brokers are getting this (I have no idea) individual direct investor stands at disadvantage."

"If you feel better disclosure should be made to clients, why not update or create a better investor guide to investing using general practices etc. and require that all licensed advisors provide each new client with that so that some of the onus will be on the investor to read this info and ensure that they understand their investments, objectives, risk tolerances etc. If you leave it up to each dealer/advisor to do this, there will be a huge variance on these what is disclosed and how it will be understood, it will create yet another huge task for all compliance departments and advisors, when we have all already been extremely overworked with implementing and working around all of the new policies, rules, reporting requirements etc. that has been dumped on us over the past 2-3 years with the creation of the MFDA, NRD, IPF, etc."

"I agree in principle with the approach but one concern I have is the simple fact that some clients will not be "educated" in spite of our best attempts - they simply do not care about all that "financial stuff" and want the advisor to carry the ball. I always explain to my clients that we feel they need to understand the strategies we are using but a good number agree while really giving it lip service. So much hinges on the personal and moral ethics of the individual advisor."

"I deal mainly in the small cap market place. I feel there is currently not enough understanding between investors and the industry in this segment of the industry. There seems to be no responsibility held by the investor when dealing with highly speculative stocks. Hence when there is a problem (as is intrinsic in this market) the burden is placed on the advisor. I would like to see this addressed. Some responsibility must be placed on the investor or this equally important part of our financial markets will dry up. IE. In any relationship the investor must be aware that any stock trading under $3.00 can possibly sustain 100% losses"

"Clients will not submit to this process. They want a quick in and no hassles about what they know or not. Too much emphasis on educating the client - he is responsible for his own education not me."

"What about risk disclosure documents (options, futures, strip bonds, leverage)?"

"This information sheets could be just simpler for average investors. The information should be presented in the same dialogue format as George and Jane's conversation."

"Can the OSC or an industry consortium produce the educational content I would need. Clients are lazy and the materials out there are not that good. They don't like to read but would watch something like the CDROM mentioned in the dialogue."

"Advisory: The majority of this process is being done in our office, however, many clients do not want the same degree of data to discuss with their advisor and may feel intimidated or overwhelmed to have so much information. The problem with the communication that goes between the public and the industry is not in too little disclosure but in too many highly detailed, complex documents that actually discourage clients from reading, discussing and understanding what advisors present them to consider. The fair dealings model may be reasonable if flexible enough to outline in clear language what the dient can expect to receive, risks, etc. but if too rigid or packaged, it will still not provide transparency."

"I believe the clients are being overloaded with information by the media. (let's not forget the media wants to sell papers and commercial time so they talk about the latest headline or worse . . . they have reporters write up stories that give the general public advice. Advice that they are not qualified to give!!! Why don't you start by regulating them first in order to stop the negative impact on our industry and misinformation?"

3.4.2 Compensation and Cost Information

Questions about fee and cost disclosure were posed for the three relationship types.

Screen: Self-Managed Transactions

Statement	Investors		Advisers	
	# Agree or Strongly Agree	# Disagree or Strongly Disagree	% Agree or Strongly Agree	*N*
Service providers should report all sources of compensation connected with investments and transactions by a "self-managed" client.	1/1	0/1	**78%**	*46*

Screen: Advisory – Transactions

Statement	Investors		Advisers	
	# Agree or Strongly Agree	# Disagree or Strongly Disagree	% Agree or Strongly Agree	*n*
Determining the amount of adviser compensation on the basis of public data requires calculations that are too complex for the average investor.	1/1	0/1	**83%**	*18*
All options and costs involved in investing in a particular security should be explained to a client before a decision is made.	1/1	0/1	**89%**	*18*
As an investor, I understand how I pay for all of the securities in my portfolio.	0/1	1/1	**67%**	*18*
I am aware of the types and total amounts of fees and commissions I pay on mutual fund and segregated fund holdings.	0/1	1/1	**61%**	*18*

There was a higher adviser response level for the survey questions regarding the Self-Managed than the Advisory relationship. Advisers were more in favour of complete cost and compensation disclosure in a Self-Managed relationship than in an Advisory one. Only 61% of advisers indicated that they understood all the fees they paid their advisers for their mutual fund holdings. Whether they were actually answering for themselves, or how they perceived their clients would answer is not clear, but the suggestion that there is a lack of transparency in this key area is unequivocal.

In the open-ended comments, there was general support for better disclosure of applicable fees. A number of advisers commented that conflicts of interest are inherent in current compensation practices and supported the use of fee-based compensation. A number of advisers supported the status quo with regard to trailer fees. Commenters suggested tougher penalties for those engaged in improper behaviour and regulatory compliance checks of individual accounts.

Selected Comments

> "[T]o provide a thorough financial planning based service, we feel the annual income generated from the portfolio needs to be 1% on a $400,000 portfolio. . . . We feel we need to earn $1500 per year for basic service. b) The trailing commission, and the product recommendation, is thus based on the revenue that needs to be generated. c) Example: For accounts under $100,000...all assets are sold on a DSC basis. . . . For accounts greater than $400,000 we are recommending products whereby we can adjust the trailer fee to be paid what we need to be paid and not more. This gives a break to the high end client because their MERs will be less under this scenario than one whereby the trailer fee is fixed at 1% for example. . . . It is important for regulators to understand that the commission earned from the typical account is not enough to provide the type of ideal service you are striving for in this new model."

“I believe that DISCLOSURE IS NOT ENOUGH to build the right environment. Advising must be separated from selling and building investment vehicles. Here are some suggested changes to reduce conflict of interest: 1) brokerages - make retail brokerages into investment stores - no advice may be offered - no commissions (front, back, or trailing) may be paid to investment advisors - customers may be charged transaction fees - commissions may be received from suppliers of investment vehicles 2) investment advisors - make them true professionals - must obtain demanding certification e.g. CFP - cannot own investment stores or sell investments -cannot own or be owned by investment vehicle supplier 3) investment vehicles (mutual funds, investment trusts, ETFs etc.) - may charge for management services - may pay commissions to investment stores - may own investment stores that do not trade individual stocks The key here is to make advisors independent. This makes for some legitimate duplication of effort because brokerage houses need to analyse potential underwritings and advisors need to analyse offerings.”

“I know you want to regulate relationships and I agree with that. But aren't products (mutual funds) a really big problem that better disclosure will not really help?”

“In summary, what is most important is to reduce or eliminate the opportunities for self-serving outcomes. I do not believe that transparency will solve this issue. Why simply show what the biases are when we have an opportunity now, in this time of reform, to eliminate the biases? In my many conversations with Mr. & Mrs. public investor I found that there is a lack of confidence that the financial services community has the investing publics' interests in mind. However, I believe that we now have an opportunity resolve these issues.”

“My clients are aware conceptually that the mgmt fee is 2.5% on managed assets and it is shared with me and that's my compensation, but calculation of the $$ amount is not useful. Reminding clients of the $$ amt of fees would only encourage frustration in markets such as today. . . . I suggest that reasonable professional compensation via trailer fees is the best model because it encourages advisors to maintain the portfolio strategy, which is usually the best thing to do - fee for service doesn't work for money management because of the long term and variable nature of the returns. If you force a fee for service model you will just encourage clients to churn advisors with each fluctuation in performance.”

“It is important that advisors are not put back in the position that they were prior to the introduction of trailer fees. At that time, many advisors felt the need to constantly sell more or resell to generate an income for themselves. The attitude that prevailed was that if the advisor did not get paid somehow, he/she will be soon out of the business. Clients are reluctant to pay the advisor directly and fell cheated if the assets decline and they are still required to pay a fee. For what they say? The amount of time that must be spent to update client files and review the accounts is quite significant and advisors are always looking for ways to reduce the administrative time spent on an account. Few manufacturers are helping and they do not concern themselves with the demands of the regulators. Thus the problems have to be solved by the advisors and it is their expense to become compliant. The slow removal of distribution company benefits like office, staff etc. only adds to the costs that advisors are faced with. Dealers are downloading their expenses onto the advisors. Liability insurance is rising and the client seems to have no idea of the financial stress that the advisors are going through right now. Old practices which many companies encouraged are being shelved with the advisors being left alone to deal with the resolution of these problems.”

"I believe the issue about fee disclosure only becomes relevant on larger accounts of $500,000+, for example. Up to that stage, smaller investors today will typically not be able to afford the typical cost of managing a portfolio. We estimate the cost of managing a typical portfolio ranges between $1000 and $1500 per year (when you factor in the time spent with the client, administration time, statements, newsletters, value added seminars and mailings, etc). Therefore: Should all fees paid be negotiated between the advisor and the client? I disagree because in most situations this discussion is irrelevant unless the client is interested in writing a cheque for $1000 or more each for the same advice they are getting today, paid by the DSC commissions."

"For those advisors who don't explain the risks adequately or give inappropriate advice the OSC should make it easier for an investor to make a complaint and the OSC should throw the book at those advisors. IE an advisor who takes a 60 year old with a moderate risk tolerance and loses half their portfolio should be forced out of the industry (I have taken over 3 such accounts in the last 16 months and the clients don't want to take it to the securities commission). Or advisors who churn their client accounts. If an advisor is found guilty of churning or making unsuitable recommendations, the OSC should audit several other of the advisor's clients and he or she should be forced out of the business and the company should face harsher fines. Hit them where it hurts, in the pocketbook. But hit them with those fines for serious wrong doing, not trivial technicalities IE. the size of the logo on my business cards (which is compliant) or if I have a couple left over prospectuses in the file cabinet from last year. I would like to see the industry cleaned up, but I don't believe more paperwork/disclosure is the answer(there is more than enough information in the prospectus, so why would clients suddenly read other documents we give them, if they don't even read what they are given?). I believe that if you punish the advisors and their firms for serious offences, the firms will take it upon themselves to weed out the bad representatives who take advantage or their client's trust. If they don't, the securities commission should be there to do it for them."

"I contend that regulatory auditors could select a given number of client accounts from any Member firm and then interview the client, the advisor and compare the findings to the assets held in the portfolio and the trading history for suitability. I believe this proactive approach would be in the public's interest."

"Advisory model seems to imply a portfolio of in-house funds or a discretionary account but there is no reason why a portfolio of 3rd pty funds can't fit into a managed strategy. It s/b OK to have a speculative account at an advisor w/o having to go to big bank. I disagree with the line about having 'to come forward in each case about a possible conflict' - this should be dealt with in an IPS at the outset. My clients don't want to be reminded at every turn of advisors who are criminals - do we require patients to acknowledge that some doctors are criminals at every visit? You seem to forget that there are good advisors out here who have done a great job setting expectations and managing assets prudently. Service level shouldn't be regulated"

"I don't think the commission disclosure is the real issue. It just opens up a whole can of worms where clients begin to dissect why something costs the way it does. We don't do this for a loaf of bread or a subway sandwich. Instead, we make the decision if we are prepared to pay the price that is offered. Value is different in every clients mind. It is up to the advisor to demonstrate that value to retain the client relationship. This is called service and establishing unique competitive advantage. Again, commission disclosure is only going to create an adversarial relationship between the advisor and the client. Either the client is going to be nickel diming all of the time or the advisor is going to have to give the client a copy of their financial statement each year to justify the expense. I truly believe the answer lies in the perceived value the client is receiving and good old fashioned competition. If some advisors want to disclose, and they gain competitive advantage for it...great! If others don't, then that may be to their peril...or not. Commission is not the issue. Value is!"

"Hind sight is 20-20 but no one knows the future but the vast majority of advisors do the best job they can. If advisors are to report all sources of compensation then why are they not required to report all sources of expenses? Different advisors work differently in what presentation/courses they attend, what services they provide at NIL additional cost to the client, what amount of money a client must have before the advisor will take them on as a client given some brokerage houses have a minimum $75,000 to $150,000 minimum - how many clients would fall into this category, etc.?"

"I think investors need to know clearly how the advisor is being paid. The "advisor" is clearly a securities salesman but he/she is not presented to us in this context. Knowing what the trailer fee and commissions that are paid to the advisor would help to understand his/her motivation."

"The suggestion that "compensation should be disclosed", seems to give little comfort to investors. I have personally had experiance with non disclosure of fees associated with the purchase of mutual funds, specifically concerning trustee and transfer fees. I have also found that the disclosure (vague as it is) of front load or back load fees, usually takes place only if the investor brings the subject up. In my opinion full written transparency of fees by the advisor is a must not an option, anything less will not achieve fair dealings."

"If firms and regulators are serious about suitability and staying within the clients investment objectives, our client account screens should have those objectives clearly visible. No one trying to do business in an even moderately busy market puts everything on hold and digs into client files every time an order is entered. Some clients are conspicuously conservative. They never cause a problem, as they never even think about violating their stated objectives. If objectives were prominently displayed with all the other client information on the system, it would be easy to remind the client prior to entering an order, that he or she was deviating from the type of investing listed on the client account form."

3.5 Ongoing Account Information and Client Communication

The survey questions invited comment on the sample "George's Portfolio Statement" presented on the website. This portfolio statement was developed to illustrate how the Fair Dealing Model transparency principle might affect ongoing account reporting.

We also put forward for comment some specific suggestions for quantitative risk measures (for both individual securities and the overall portfolio) that could form part of the portfolio statement.

Screens: Portfolio Statement and Risk Analysis

Statement	Investors		Advisers	
	# Agree or Strongly Agree	# Disagree or Strongly Disagree	% Agree or Strongly Agree	*n*
Common approaches to risk analysis and communication should be adopted by the investment industry.	7/7	0/7	**74%**	*23*
A graphical illustration of the risk level of each security and of the overall portfolio should appear in the monthly statement.	4/5	1/5	**83%**	*23*
A monthly statement should include a measure of how the portfolio is performing on a risk-adjusted basis.	6/6	0/6	**74%**	*23*
A monthly statement should include an indication of the portfolio's diversification.	6/6	0/6	**96%**	*23*
A full value-at-risk calculation is necessary given the importance of the investment process.	2/2	2/2	**65%**	*23*

The survey questions provoked a high level of response. There was a high level of support for creating industry standards for communicating risk, and for presenting quantitative risk measures to investors. However, in the open-ended comments, a number of industry people addressed the difficulty of conveying information about risk, although one adviser indicated that he/she has been doing so successfully. Interest in receiving this information was expressed on the investor side.

Selected Comments

> "How would clients ever understand this? How would you ever regulate it? There has to be a way for us to use an IPS with some kind of downside risk (the Trimark best and worst performance numbers in their monthly booklet is excellent) so that the client understands the portfolio and its components without getting the regulators into all this stuff."

> "I reviewed many aspects of the risk definitions but as a former "risk" management person in financial services I have doubts about the ability of any "document" to be able to convey and any system to "measure" all risks - at base it will be a "consensus" view of risk valid for a particular point in time -perhaps for a day perhaps for a week but difficult to "police" in volatile times - for example if there are

many debt defaults in corporate and national issues would the US and Canadian banks be a high risk or a low risk investment - if someone advised someone to go into the banks stocks say 6 months ago are they more or less risky today in relation to other dividend producing stock - who would want to be responsible for making the call that it is more risky today than previously and is it now less risky because say TD fell by 40%. I personally only trust my own investment judgement but I worry that if there is a set of "rules" that increases the costs and liabilities of various players that transaction costs will go up to protect the "victims" of poorly understood relationships”

“Before we take investment instructions the risk rating system is explained to the client. I don't seem to have the problems with the clients as presented on the website.”

“I would like to know more about my ongoing risk and be able to compare it to some standards. Many of the decisions my adviser asks me to make have too little context and I have to rely on her opinions too much.”

“Concepts like Beta and risk adjusted rates of return will be very difficult to communicate to most clients. Although I agree that these are important tools, I think that it is unreasonable to assume that we can explain these concepts to all clients - I would start by ensuring that the advisors understand them. This alone would be a vast improvement.”

“The significance of Betas are being undermined by the media. Their micro-coverage causes over-reactions and promotes volatility because they make money from it. If the markets were more stable, there would be half the volume of content to fill the business section.”

“The state of risk analysis technology is generally poor. Few advisors outside serious quantitative analysts understand risk metrics, let alone how to use them. I doubt very much if there are five firms in Canada that can calculate a portfolio beta. Using confusing jargon such as beta and value-at-risk may make the advisor sound intelligent but what objective test of skill and ability can be brought to the question. The only convincing demonstration of risk analysis that I have ever seen involved trading securities on volatility metrics. This approach produces consistent results but no one beyond the practitioner understands it. Try to educate the typical retail investor on that reality. Therefore, introducing risk measurement to something so inherently biased as selling mutual funds does not level the playing field. The only good advice in the past three years has been stay out of the stock market. I hear scary stories about investors who were consistently told that things will improve so it is best to hold on. Now they have lost confidence in the system. Your drama about the advisor coaching George is no more than lipstick on the same old pig.”

The survey questions also invited comment on the reporting of cost and performance disclosure in the sample "George's Portfolio Statement

Screens: Portfolio Statement: Costs and Performance

Statement	Investors		Advisers	
	# Agree or Strongly Agree	# Disagree or Strongly Disagree	# Agree or Strongly Agree	# Disagree or Strongly Disagree
A clear indication of the performance of individual securities and the overall portfolio would benefit a self-managed investor.	4/5	1/5	8/10	2/10
The investor should be informed in the regular statement of all compensation received by the service provider related to each transaction.	5/5	0/5	10/11	1/11
Comparing the performance of the portfolio to relevant benchmarks in the statement would be useful to a self-managed investor.	5/5	0/5	7/9	2/9
I would find it helpful to receive information about the actual return on my investments.	1/1	0/1	1/2	1/2

There was a positive response to survey questions relating to performance and compensation disclosure in the portfolio statement. Although personal portfolio performance does seem to be a key issue, there was a low response to this survey question.

There was more support in the open-ended answers for personal portfolio performance reporting. Commenters mostly supported the inclusion of more information on returns, although negative comment also was received, both generally and on the use of benchmarking.

Selected Comments

> "The proposed measurements will be costly to establish and to monitor and will reduce the rates of return on investments and is contrary to the investors' interest."

> "The fees paid should be more related to funds performances. Why not calculate them as a proportion of the funds returns? -the real cost of management should appear on the statement for each portfolio like taxes are shown on bills. Why not a net and gross rate of return?"

> "The suggested statement format is excellent, as long as the rules for calculations are also clearly defined. e.g. how to handle the value of securities deposited in an account, how to handle return of capital from Income Trusts as reflected in the Adjusted Cost Base, and the effect of companies spinning off subsidiaries and issuing shares in the spin-off to current shareholders."

> "Current statements are so poor that investors have to do a lot of their own analysis."

“The statement I get every month from [a firm] never indicates the performance of my portfolio as a whole. There is also no information about individual funds. In the education saving plan I have, I am told the fund is going up but the statement indicates a loss. There is a need for more transparency on the true return of funds and portfolios and returns should be clearly indicated on every statement.”

“Performance measurement is extremely complex and attempts to simplify it are very dangerous. For example is the TSE the relevant benchmark for Canadian stocks in 1999? If something drops 5% in the first year do you get rid of it? If a great manager like . . . is 4th quartile for 3 years in 1999 do you fire him? How do you regulate what start date the ror calculation should use if the client transfers in an asset from another account? Do you time weight the returns or dollar weight? How would you ever explain that to a client? The excellent advisor's job is to interpret all the noise out there and there's no way you can regulate that.”

“How is the advisor going to have any time to research products as they'll be too busy documenting things, sending out notices if the markets fall as the value of the client's investment may have fallen below 15% or whatever threshold has been established.”

“If the targets are not met what is the investor to do? Put in more money that he doesn't have? If he does have the money how many will jump into a down market - very few. If the markets are doing well and going up it could give him a false sense of security in that the investor is ahead of targets and therefore he can cut back on what he is investing. This may the absolute worst thing he could do as the markets will eventually drop back and the investor could be in a difficult situation based on their objectives as the money they did not invest could have been spent on extras that the investor could have easily done without.”

“The investor must understand that performance goals are not guaranteed. Even securities of "blue chip" firms can go down significantly. This does not necessarily mean the advice was bad. Further, the investor has an obligation to monitor the securities in his or her portfolio as well as the advisor. It should be understood that it’s a shared responsibility. Advisors should not be held accountable for failing to recommend a "sell" of a security at its peak. This would be applying 20/20 hindsight and would make the advisor an insurer of the investor's security gains.”