FAIR | Canadian Foundation *for* Advancement *of* Investor Rights
Fondation canadienne *pour* l'avancement *des* droits *des* investisseurs

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Re: Request for Comment on Requirements and Best Practices for Distribution of Non Arm's-Length Investment Products

We are pleased to provide you with the comments of the Canadian Foundation for Advancement of Investor Rights (**FAIR Canada**) in response to the Investment Industry Regulatory Organization of Canada's (**IIROC**) request for comments on its proposed requirements and best practices for distribution of non arm's-length investment products (**draft guidance note**).[1]

FAIR Canada is a non-profit, independent national organization founded in 2008 to represent the interests of Canadian investors in securities regulation. Additional information about FAIR Canada, its governance, and priorities is available on our website at www.faircanada.ca.

Summary of Recommendations

We strongly support IIROC's regulatory initiative. We believe our recommendations will help make the final guidance note more robust.

In order to ensure truly fair and efficient markets and to foster investor confidence, intermediaries must always resolve conflicts of interest in favour of their clients. The applicable standards of conduct must be clarified to ensure this happens.

[1] IIROC Rules Notice 10-0028, *Request for comments on draft "Requirements and Best Practices for distribution of non arm's-length investment products*" (February 5, 2010).

Our principal recommendations are as follows:

1. **Clarify how members are to put the client's best interests first**. The standards for Dealer Members need to be clarified, and it should be a higher standard than the current "suitability" one. IIROC rules should clearly provide that dealer members should not sell non arm's-length products to clients where such a sale is not in the best interests of the client.

2. **Provide more definitive guidance about what constitutes acceptable disclosure to the client**. Dealer members should provide clear and concise disclosure to allow their clients to fully and fairly assess the product being offered. Dealer members should be required to maintain objective evidence that the client actually understood the product and related risks.

3. **Redraft the draft guidance note to clarify which provisions are mandatory, and any mandatory provisions should be set out in an IIROC rule**. As discussed below, the language in parts is inconsistent with the statement that non-compliance with the notice would constitute grounds for enforcement action. A rule should *require that* the Dealer Member's compliance policies and procedures comply with the contents of the draft guidance note.

4. **IIROC rules should require that IIROC Dealer Members have policies and procedures in place to:**
   (i) identify non arm's-length products; (ii) perform adequate due diligence on the products; (iii) assess conflicts of interest and suitability for each client to whom the products are sold; and (iv) provide IIROC with advance notice of certain product distributions.

Our specific recommendations follow.

1. Clarify how members are to put the client's best interests first.

FAIR Canada believes that both clients and advisors would benefit from greater clarity about a Dealer Member's obligations toward its clients. There should be an explicit requirement to put a client's best interests first. While we would advocate this standard for all transactions, it is transactions where conflicts of interest are present, such as the sale of non arm's-length products, where the need for this requirement is most pressing.

In Canada, dealers are generally held to a suitability standard, and must act honestly, fairly and in good faith toward their clients. But they are not always required to put their clients' best

interests ahead of their own interests. This means that a dealer may offer a client investment advice that, while "suitable" for the client, may be more costly and not necessarily in the client's best interests.

<u>Recommendation #1:</u> We recommend that the suitability standard be broadened to encompass a requirement for a dealer and its registered representatives to put their clients' best interests first.

We further recommend that the best interest assessment include determining whether there are arm's-length products that are more suitable for the client. For example, if there is an arm's-length fund that is substantially similar to a non arm's-length fund and has lower fees and expenses, the client should be offered the arm's-length product (or at least the Dealer Member should present the arm's-length product as an option to the client).

For some products sold to retail clients, disclosure is not sufficient and, in those cases, the products should not be sold to those investors. For example, it is generally not be in the best interests of retail investors for a firm to sell debt securities of a non arm's-length issuer unless the debt securities are those of a regulated financial institution, rated as investment grade by a credit rating agency or sold by prospectus. It is our understanding that there have been a number of cases where retail investors have sustained significant losses where firms have sold debt products of an affiliate (one example is the Essex case). Therefore, the guidance note (or rule) should expressly state that, for certain non arm's-length products, disclosure is not sufficient and the product should not be sold to retail clients.

2. Provide more definitive guidance as to what constitutes acceptable disclosure to the client.

The draft guidance note states that "[i]n the case of non arm's-length products, the incentive and ability to provide full and meaningful disclosure to an investor may be impaired." While we agree that the incentive to provide full disclosure may be impaired, there is no reason why the ability should be. In fact, because of the relationship between the Dealer Member and the issuer, the Dealer Member should have better access to information about the issuer than for arm's-length products.

The need for full, true and plain disclosure to protect investors was highlighted in the recent Securities and Exchange Commission (**SEC**) filing of civil fraud charges against Goldman, Sachs &

Co. (**GS**).[2] The SEC alleges that GS sold subprime mortgage-backed securities to investors while failing to inform them that the underlying mortgages were selected by a third party that stood to profit if the investment declined in value. The mortgaged-backed securities were sold to sophisticated institutions, who likely would not have bought them had the alleged conflict of interest been disclosed. This matter highlights the need for investors to be provided with clear, comprehensive disclosure of all information required by the client to make a fully informed decision, and for robust rules to be in place requiring a firm and its registered representatives to put a client's best interests first.

Any disclosure must be meaningful to be of assistance to the client. It cannot be vague, boilerplate, in "legalese," or contained in a document so lengthy that a client will be dissuaded from reading and digesting it. The member should also be fully satisfied that the disclosure is properly understood by the client.

The draft guidance note should therefore be more specific about the nature of the disclosure to be provided. While it references IIROC Dealer Rules 5.9 to 5.13 (regarding the public distribution of a Dealer Member's securities), it is not clear how those rules relate to other transactions. For example, does the requirement in Dealer Rule 5.10 that a Dealer Member obtain at least two independent valuations of the securities to be sold apply to all distributions of non arm's-length products?

<u>Recommendation #2:</u> We therefore recommend that, prior to the sale of a non arm's-length product to a client, a Dealer Member provide the client with plain language, concise, written disclosure detailing:

- **i. the nature of the product,**
- **ii. fees, commissions, promotions and inducements of any kind payable to the Dealer Member or its registered representatives in connection with the sale of the product,**
- **iii. the Dealer Member's or related party's interest in the product,**
- **iv. risk factors tailored to the specific product,**
- **v. the availability of comparable arm's-length products,**
- **vi. whether the investment is covered by Canadian Investor Protection Fund, the**

[2] *The SEC charges Goldman Sachs with fraud in connections with the structuring and marketing of a synthetic CDO*, at www.sec.gov/litigation/litreleases/2010/lr21489.htm (viewed April 17, 2010).

vii. **Canadian Deposit Insurance Corporation or similar entities, and**

viii. **all other information necessary to allow the client to understand the conflict of interest and to fully and fairly evaluate the product.**[3]

The Dealer Member should be required to produce objective evidence that the disclosure was understood by the client, including disclosure relating to fees and risks. Objective evidence could include a summary document (similar to the Fund Facts document proposed for mutual funds) that is signed by the client.

3. **Redraft the draft guidance note to clarify which provisions are mandatory**.

The request for comments states that the draft guidance note sets out staff's expectations regarding distributions of non arm's-length products by IIROC Dealer Members to their clients. The draft guidance note itself says "[t]he conduct of any Dealer Member, its approved persons or its employees and agents in respect of any such distribution not in compliance with IIROC Dealer Member Rules *and the terms of this Notice* may constitute grounds for enforcement actions by IIROC on the basis of such non-compliance and conduct being unbecoming a Member…"

While IIROC's intent seems clear, the use of precatory language dilutes this intention. For example, the draft guidance note states that if the Dealer Member is not satisfied that the conflicts of interest can be addressed in the client's best interest, the product *should* not be sold to any client. The obligation would be clearer if the language were stated imperatively: the product *must* not be sold to any client. Even the use of the term "best practices" suggests an industry consensus rather than hard and fast rules.

This is even more problematic given that the draft guidance note sometimes states that a Dealer Member *should* do something and at other times states the Member *shall* do something. If, as noted in the draft guidance note, non-compliance with the terms of this notice may constitute grounds for enforcement actions by IIROC on the basis of such non-compliance and conduct being unbecoming a Member, we recommend that the contents of the draft guidance note be made into an IIROC rule. This would facilitate enforcement by IIROC of the provisions in the draft guidance note.

[3] This would include whether any third party associated with the product, arm's-length or not, has a conflict of interest.

<u>Recommendation #3:</u> We recommend that the draft guidance note be redrafted to clarify which provisions are mandatory and which are suggested practices. This will assist both Dealer Members and investors. We further recommend that any mandatory requirements in the guidance note be made into an IIROC rule, to better assist dealer members in understanding which provisions are guidance and which are mandatory. Setting out mandatory requirements in a rule would help with enforcement of the concepts articulated both in the rule and the draft guidance note.

4. Policies and Procedures

<u>Recommendation #4:</u> To ensure that the terms of the draft guidance note are followed, we recommend that IIROC enact a rule which would make it mandatory[4] for IIROC Dealer Members to have policies and procedures in place to:

i. **identify non arm's-length products,**
ii. **perform adequate due diligence on such products,**
iii. **assess conflicts of interest and suitability for each client to whom the products are sold, and**
iv. **provide IIROC with advance notice of certain product distributions.**

The specific examples in the draft guidance note should be listed as minimum requirements for the Dealer Member's conflict of interest policies rather than best practices.

5. Drafting Comments

Finally, we have a number of drafting comments for your consideration:

1. Page 7, under "Products": Add "derivative or structured products".
2. Page 7, under "Products": The "exempt" products category should be listed separately, as exempt products are not technically a category of financial products.
3. Page 9, top of page: Clarify what is meant by "street rates", and add the word "reasonable" to describe the commissions on underlying fund asset trades.

[4] IIROC could exempt a Dealer Member from this requirement if the Dealer Member's own internal policies prohibit the sale of non arm's-length products to clients.

We would be pleased to discuss our comments with you in more detail, including ideas about content for the suggested rule. Feel free to contact Ermanno Pascutto at 416-572-2282 / ermanno.pascutto@faircanada.ca or Ilana Singer at 416-572-2215 / ilana.singer@faircanada.ca.

Sincerely,

Canadian Foundation for Advancement of Investor Rights