FAIR | Canadian Foundation *for* Advancement *of* Investor Rights

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John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, ON M5H 3S8
Fax: 416-593-2318
E-mail: comments@osc.gov.on.ca

Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, tour de la Bourse
Montréal, QB H4Z 1G3
Sent via e-mail to: consultation-en-cours@lautorite.qc.ca

RE: Canadian Securities Administrators ("CSA") Consultation Paper 33-403: *The Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients* (the "Consultation Paper")

FAIR Canada is pleased to offer comments on the Consultation Paper issued by the CSA regarding the desirability and feasibility of introducing a statutory best interest duty for advisers and dealers.

FAIR Canada is a national, non-profit organization dedicated to putting investors first. As a voice of Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit www.faircanada.ca for more information.

General Overview

FAIR Canada strongly believes that dealers and advisers should be required to act in their client's best interest and that a statutory best interest duty must be introduced in order to protect investors. We believe that a statutory best interest standard is highly desirable and feasible. We will expand on these two key aspects below.

The existing regulatory requirements and industry practices do not provide adequate protection for consumers of financial services in Canada. The introduction of a statutory best interest standard for dealers and advisers would result in:

- increased protection for consumers;
- better financial outcomes for consumers;

- more effective competition;
- an increase in the level of professionalism in the financial services industry; and
- an increase in the level of trust in the financial services market.

FAIR Canada urges the CSA to implement a statutory best interest duty as promptly as possible in order to protect Canadian consumers and keep pace with other leading jurisdictions.

For the reasons set out below, FAIR Canada believes that dealers and advisers should be required to act in their client's best interest and that a statutory best interest standard must be introduced in order to protect investors. We include in Appendix A a list of defined terms.

Summary of Benefits of a Best Interest Standard:

1. Benefits: The introduction of a statutory best interest standard for dealers and advisers would result in:
   - increased protection for consumers;
   - better financial outcomes for consumers;
   - more effective competition;
   - an increase in the level of professionalism in the financial services industry; and
   - an increase in the level of trust in the financial services market.
2. Conflicts of Interest – A best interest duty would require regulators to consider whether embedded commissions are compatible with the best interest duty. FAIR Canada has great difficulty in understanding how an adviser or dealer (or their representative) required to act in the client's best interest could accept payments from a third party and fulfill their duty to the client.
3. Costs - A best interest duty would improve outcomes for consumers because it would explicitly require registrants to consider the investment costs in determining whether the investment is in the best interest of the consumer.
4. Professionalism – A best interest duty would enhance the professionalism of the financial services industry and enhance public trust in the industry. Further, it would assist the financial advice industry in its ambition to be recognized as a profession.
5. Agency Costs - A best interest duty will reduce investors' agency costs, which arise as a result of conflicts of interest, and which have a huge negative impact on consumer's long-term savings. In particular, financial consumers will no longer need to analyze recommendations from financial advisors to factor in the effect of conflicts of interest, which research has demonstrated they are ill-equipped to do.
6. More Objective Recommendations - A best interest duty, which addresses issues relating to conflicted remuneration, will reduce bias in recommendations, thus making recommendations

more objective. It will also eliminate much of the need for conflicts disclosure, which has been demonstrated not to work and to cause unintended negative consequences for investors.

7. Informed Consumer Choice and Innovation - A best interest duty will facilitate more informed consumer choice about the purchase of advice. We expect that, if embedded commissions were prohibited, investors would be encouraged to look more critically at what they are getting for what they pay. This would improve competition and economic forces would spur innovation in the delivery of cost-effective advice that meets a best interest standard.
8. Obligations will Meet Expectations - A best interest duty would improve consumers' trust in the financial services industry, as obligations will meet financial consumers' expectations.
9. Improved Consumer Outcomes - A best interest duty would improve outcomes for consumers because it would ensure the most efficient allocation of responsibilities between the advisor and the consumer given the level of financial literacy of consumers, the degree of knowledge, specialized skills and abilities that the advisor needs to possess, and the complexity of financial products.

Summary of FAIR Canada Recommendations:

1. Best Interest Duty Recommended - FAIR Canada recommends that CSA members implement a statutory best interest duty for advisers and dealers when advice is provided to retail clients. FAIR Canada recommends that the CSA implement a statutory best interest duty as promptly as possible in order to create market conditions where advisers and dealers must determine that the products they recommend are in the best interests of their clients.
2. Conflicts of Interest - Regulators must consider, either within the best interest initiative or through a separate consultation, whether embedded commissions are compatible with the best interest duty. FAIR Canada has great difficulty in understanding how an adviser or dealer required to act in the client's best interest can accept payments from a third party which itself has a duty to investors. A best interest standard should include a prohibition against the acceptance of embedded commissions. In order to be independent, advisors should be paid by the consumers they serve.
3. Applicable to All Registrants - A statutory best interest standard should apply to any advice or recommendation provided by securities registrants, including recommendations or advice not to purchase or sell securities.
4. Standard of Care - The best interest standard must include a duty to act honestly and to owe a duty of loyalty or duty of utmost good faith to the consumer. The standard of care should be that the adviser, dealer and financial service provider will perform their services with the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances, having regard to the special knowledge or experience that it is reasonable to expect of a person acting in that type of financial services business and having regard to any special knowledge or experience that the person holds himself or herself out as having.
5. The Duty of Care - The duty of care would be the same regardless of the sophistication of the client, but the steps taken to meet the duty will vary depending on the circumstances of the particular case.

6. Assessment of the Standard - When assessing the conduct of dealers and advisers, a court or arbiter should not substitute their own decision for that of the advisor, as long as the latter's exercise of judgment as to what was in the consumer's best interest was reasonable, sound or prudent in the circumstances, at the time the advice or recommendation was provided to the consumer.

7. All Retail Investors - The best interest duty should be owed to all natural persons receiving advice for personal, family or household reasons and also for advice regarding investments held through personal holding corporation vehicles.

8. Mutual Fund Dealers - If the firm and its advisors are limited in the products that they sell (for example, only registered to sell mutual funds) then the advisor must investigate and consider products outside their registration to show that they have acted in the best interest of the client. If the advisor is unable to recommend a product due to its being outside the scope of their registration, but such product would be in the client's best interest, the advisor must inform the consumer of the type of products that the client should investigate further, and advise the client which type of financial service firms it can be obtained through (with or without "advice"; for example, through a discount brokerage). This would necessitate expanded proficiency and expanded registration, for example, to sell exchange-traded funds.

9. Two Tier Model - FAIR Canada believes that all investment advice should be subject to a best interest duty. However, we understand that given the structure of the industry, some current business models would need to be modified significantly in order to be economically viable under a best interest standard. If regulators are not willing to impose a best interest standard on all existing business models, FAIR Canada recommends that regulators take a phased approach, and those who would need to modify their business model in order to meet a best interest duty to consumers (where they would have a wide enough product list to practically meet a best interest standard) be permitted to provide "restricted advice" similar to the model in the U.K.

10. Restricted Advice - FAIR Canada recommends that those who provide "restricted advice" must use the title "salesperson"; be subject to suitability requirements; be precluded from holding out that they offer independent advice or holding out that they act in the best interest of the client; and must disclose in writing and orally that they are providing restricted advice, which is not required to be advice in the best interest of the consumer (i.e. "independent advice").

    All registrants, whether providing restricted advice or independent advice, should be precluded from using conflicted remuneration structures.

11. Ongoing Duty - If the consumer pays for ongoing advice, they should be provided ongoing advice and the obligation to provide advice in the client's best interest should be ongoing. On the other hand, if they request and pay for one-time advice, there is no ongoing relationship and the duty, correspondingly, should not be ongoing. The overriding issue is whether the relationship is ongoing and payment structures should not be designed to circumvent one's obligations.

12. Discount Brokerage - Given that discount brokerages do not restrict their services to mere order taking, FAIR Canada recommends that CSA members examine the services provided by discount brokerages and assess whether certain services that are provided to customers

should be subject to a best interest standard. Furthermore, FAIR Canada recommends that the issue of conflicts of interest between discount brokerages and their clients be considered by CSA members and addressed in the context of implementing a best interest duty.

13. Sales of Non-Securities - A statutory best interest duty should apply to a recommendation by a securities registrant to purchase a segregated fund or a principal protected note or other investment product regardless of whether it falls under the provincial securities legislation's definition of "security". The recommendation to invest in comparable products necessarily constitutes advice about securities (that is, a recommendation to not invest in a security) and should therefore be subject to a best interest standard. Failure to apply the standard to a registrant selling non-securities products will create incentives to sell such products to avoid consumer protection.

14. Refuting Industry Lobby Arguments - Throughout this submission, FAIR Canada articulates the benefits of a best interest duty and refutes industry's arguments that it is unfeasible due to perceived additional costs. FAIR Canada believes:

    - Business models will evolve through market forces to serve consumers' needs;
    - Costs of advice will not be higher;
    - Legal costs will be lower;
    - Products will emerge and be promoted that meet consumers' needs; and
    - Quality of advice will improve as will the quality of interactions between the consumer and advisor, leading to better outcomes for consumers.

15. Cost-Benefit Analysis - FAIR Canada questions the efficacy of attempting a quantitative cost-benefit analysis to determine whether to implement a best interest standard. Such an analysis risks being (1) highly inaccurate and (2) not the correct yardstick with which to measure the concept of a statutory best interest duty. It is exceptionally difficult to quantify the value of consumer protection, and we do not believe that this is the appropriate approach to justifying the imposition of a best interest duty.

16. No Delay - FAIR Canada strongly believes that it is desirable and feasible to implement a best interest duty that ensures that consumers are protected and that they are able to have access to the financial services that they need to achieve their retirement or other investment goals. We urge the CSA to not delay and to move forward to implement such a duty as soon as possible.

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1. The Impetus for Change

1.1. International best practices in financial consumer protection have made important strides in recent years, including in Australia, the United Kingdom, and the United States, leaving Canadian standards at a lower level than those in leading jurisdictions. As outlined below and in the Consultation Paper, similar conditions have existed in these countries leading to reform in the consumer interest.

Australia

1.2. In April 2010, the Australian government announced reforms to financial advice (referred to as the Future of Financial Advice (or "FoFA") initiative) aimed at improving "the trust and confidence of Australian retail investors in the financial planning sector"[1] which were designed to "tackle conflicts of interest that have threatened the quality of financial advice that has been provided to Australian investors, and the mis-selling of financial products…"[2] The reforms were the government's response to an inquiry into financial products and services in Australia[3] which recommended an explicit statutory "fiduciary duty for financial advisers… requiring them to place their clients' interests ahead of their own."[4]

The United Kingdom

1.3. Similarly, in the U.K., the Retail Distribution Review[5] ("RDR") aimed "to help consumers to achieve a fair deal from the financial services industry and have confidence in the products they buy and in the advice they take."[6] The original RDR discussion paper[7] identified many problems with respect to advice provided to retail consumers, including consumer difficulty in determining the 'price' of a financial product, misalignment of incentives for advisors (and heavy reliance on advisors by consumers), and widespread cases of mis-selling.

The United States

1.4. In the U.S., one of the purposes of enacting the *Dodd-Frank Act*[8] was "to protect consumers from abusive financial services practices". This sweeping legislation was aimed, among other things, to address systemic problems resulting from the sale of overly complex and widely misunderstood financial products. *The Dodd-Frank Act* mandated that the U.S. Securities and Exchange Commission (the "SEC") conduct a study to evaluate the effectiveness of existing legal or regulatory standards of care for those providing personalized investment advice and recommendations about securities to retail customers.[9] The SEC staff report[10] identified problems of investor confusion and the expectation that all advisers providing personalized investment advice about securities are required to act in the investor's best interest. The SEC staff report also found evidence of investor uncertainty with respect to the meaning of the

[1] Media release by Chris Bowen, Minister for Financial Services, Superannuation and Corporate Law, "Overhaul of Financial Advice" (April 26, 2010), online: <http://ministers.treasury.gov.au/DisplayDocs.aspx?doc=pressreleases/2010/036.htm&pageID=003&min=ceba&Year=&DocType=0>.

[2] *Ibid.*

[3] Parliamentary Joint Committee on Corporations and Financial Services, "Inquiry into financial products and services in Australia" (November 2009), online: <http://www.aph.gov.au/binaries/senate/committee/corporations_ctte/fps/report/report.pdf>.

[4] *Ibid*. at page 150.

[5] Financial Services Authority, "A Review of Retail Distribution" (June 2007), online: <http://www.fsa.gov.uk/pubs/discussion/dp07_01.pdf>.

[6] *Ibid*. at page 3.

[7] *Supra* note 5.

[8] *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Pub. L. No. 111-203, 124 Stat. 1376 (2010) [*The Dodd-Frank Act*].

[9] *The Dodd-Frank Act* at sec. 913.

[10] U.S. Securities and Exchange Commission (Staff), *Study on Investment Advisers and Broker-Dealers – As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (January 2011), online: <http://www.sec.gov/news/studies/2011/913studyfinal.pdf>.

multiple titles used by investment advisers and broker-dealers. The SEC staff report recommended a uniform fiduciary standard of conduct that would apply to broker-dealers and investment advisers when they provide personalized investment advice about securities to retail customers.

International Obligations

IOSCO – Principles Relating to Market Intermediaries

1.5. Canada's securities laws should also live up to its international obligations by implementing a statutory best interest duty. The preamble to the International Organization of Securities Commission's ("IOSCO") Principles Relating to Market Intermediaries[11], which is intended to provide IOSCO's interpretation of its *Objectives and Principles*[12], states, among other things,

> Market intermediaries should conduct themselves in a way that protects the interest of their clients and helps to preserve the integrity of the market. Fundamental principles include:
>
> - A firm should observe high standards of integrity and fair dealing.
> - A firm should act with due care and diligence **in the best interests of its clients** and the integrity of the market.
>
> …
>
> - A firm should **not place its interests above those of its clients** and should give similarly situated treatment to similarly situated clients…[13] [emphasis added]

1.6. The IOSCO Principles are recognized as the international regulatory benchmarks for all securities markets. Given that the Ontario Securities Commission and the Autorité des marchés financiers are ordinary members of IOSCO and that the Alberta Securities Commission and the British Columbia Securities Commission are associate members, we would expect the CSA would regulate in accordance with IOSCO's principles.

G20 High Level Principles on Financial Consumer Protection

1.7. Principle 6 of the G20 High Level Principles on Financial Consumer Protection[14] states that

> [f]inancial services providers and authorised agents should have as an objective, to work in the **best interest of their customers** and be responsible for upholding financial consumer protection… the **remuneration structure** for staff of both financial services providers and authorised agents **should be designed to encourage responsible business conduct, fair treatment of consumers and to avoid conflicts of interest**.[15] [emphasis added]

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[11] International Organization of Securities Commissions, *Methodology: For Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation* (September 2011), online: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD359.pdf>.

[12] International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation* (June 2010), online: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf>.

[13] *Supra* note 11 at page 177.

[14] Organization for Economic Co-operation and Development, *G20 High-Level Principles on Financial Consumer Protection* (October 2011), online: <http://www.oecd.org/daf/financialmarketsinsuranceandpensions/financialmarkets/48892010.pdf>.

[15] *Ibid.* at page 7.

Canada

1.8. While the CSA's Consultation Paper clearly and concisely outlines the reforms underway in leading jurisdictions, FAIR Canada believes that the underlying impetus for these reforms is important to emphasize. The general themes behind the initiatives in the other jurisdictions were:

(1) investor confusion regarding advisors' obligations;
(2) general unfairness in the selling of financial products;
(3) conflicts of interest threatening the quality of advice;
(4) mis-selling and poor quality advice;
(5) a lack of confidence in advice (particularly in the U.K. and Australia);
(6) a lack of awareness of the costs of advice;
(7) the realization that selling of poor financial products to unwitting investors/consumers can also lead to systemic risk; and
(8) a recognition of the shift of the burden for saving for retirement and the broad societal implications of widespread retirement saving shortfalls.

1.9. ***Same Issues in Canada*** **- These issues also lie at the root of calls for better investor protection in Canada in relation to investment advice.** FAIR Canada sees no reason why Canadian investors would be afforded a lower level of protection. Canadian securities regulators need to catch up to other jurisdictions in order to fulfill their investor protection mandates. As demonstrated by numerous investor studies, Canada is no exception to issues identified by leading jurisdictions. Some opponents of the imposition of a best interest duty categorize such a regulatory initiative as a "knee jerk" reaction to a problem. We respectfully disagree.

1.10. ***The Fair Dealing Model*** - Discussion of the legal relationship between investors and their financial service providers has been ongoing at least since the OSC's Fair Dealing Model in 2004.[16] The Fair Dealing Model proposed to "…regulate the industry on the basis of the relationships people and firms form, rather than the products they buy and sell."[17] The Fair Dealing Model recognized the lack of transparency, the lack of a clear understanding between the financial service provider and the client of their respective responsibilities, and the prevalence of conflicts of interest, including the misalignment of incentives created by the payment of third party commissions. The Fair Dealing Model proposed solutions to address these issues. Unfortunately for consumers, the Fair Dealing Model was never implemented and aspects of it were carved up into different areas of responsibility.[18]

1.11. ***Consumer Confusion*** - Since the Fair Dealing Model's release, much research has been conducted that points to a strong need for a statutory best interest duty. In particular, evidence demonstrates that "[s]ome 7 out of 10 investors believe their advisor has a legal duty to put the client's best interest ahead of his or her own. They rely on their advisor to select the best

[16] Ontario Securities Commission, *The Fair Dealing Model* (Concept Paper) (January 2004), online: <http://www.osc.gov.on.ca/documents/en/Securities-Category3/cp_33-901_20040129_fdm.pdf>.

[17] OSC News Release "Fair Dealing Model Concept Paper Fleshes Out Details of Major OSC Reform Proposal" (January 29, 2004), online: <https://www.cifps.ca/Public/Media/Pdf/OSCNewsRelease.pdf>.

[18] It had sought a far-reaching overhaul of all of the rules affecting retail financial services based on simplicity and maximizing investor access to investment instruments regardless of the distribution channel. To further transparency, the Fair Dealing Model had called for timely and meaningful disclosure of investment characteristics, risks, account performance, and all advisor fees. The OSC had even considered prohibiting fund managers from paying sales incentives to investment dealers out of fund assets and instead requiring dealer firms to charge their clients directly for the services provided.

investment for them and most believe the advisor will recommend what is best for the client even at the expense of their own commission."[19] Combined with the fact that "[i]nvestors have little or no idea about how advisors can get paid", it is clear that investors do not understand the nature of their relationships with their advisors, nor do they know the potential for conflicts of interest.

1.12. ***Heavy Reliance*** - Recognizing that the nature of the relationship between advisors and clients is a spectrum ranging from full trust and advice to execution only, advice is typically a recommendation upon which investors place a great deal of reliance. A report to The Joint Standing Committee on Investor Issues[20] found that "[f]ully one-quarter (26%) report that they decided based solely on their advisor's verbal recommendation. Likewise, one-fifth (19%) skimmed the documents their advisor provided and decided based on their advisor's verbal recommendation."[21] A further 21% "carefully reviewed their advisor's documents, decided based on those documents and the advisor's verbal recommendation". In total, this report found that 45% of investors made their decision to invest based almost solely on their advisor's verbal recommendation, and 66% made their decision based primarily on their advisor's verbal recommendation.[22]

1.13. ***Asymmetry in Knowledge and Experience and Induced Trust and Reliance*** - This trust and reliance is in part due to the significant asymmetry in knowledge and expertise between the advisor and the client. It can also be attributed to representations in marketing materials and advertisements that are intended to, and do, induce trust and reliance. In most cases, there is reliance on the judgment and expertise of the advisor; otherwise, the advisor would not have been retained to provide advice. This asymmetry of knowledge and experience also causes a relationship of vulnerability.

1.14. ***Downloading of Responsibility for Retirement Saving*** - Governments and employers are shifting the onus of making investment decisions for retirement savings onto individuals. Defined benefit plans are on the wane. Government and employers previously made investment decisions on behalf of employees and citizens which were subject to a fiduciary duty. Canadians now have to rely more on their own savings to get them through retirement years. **In FAIR Canada's view, given the reduction in protection resulting from the shift to self-directed retirement savings, it is imperative that Canadian financial consumers are afforded additional protection for their investing decisions.** Better protection for financial consumers who are saving for their retirement will result in better outcomes for retirees and for the public as a whole.

2. The Problems

2.1. ***Inadequacy of Current Regulation*** - The current Canadian securities regulatory regime as it pertains to advice for retail investors is inefficient and does not facilitate healthy competition. It does <u>not</u>:

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[19] The Brondesbury Group, *Investor behaviour and beliefs: Advisor relationships and investor decision-making study* (2012) (prepared for the Investor Education Fund), online: <http://www.getsmarteraboutmoney.ca/en/research/Our-research/Documents/2012%20IEF%20Adviser%20relationships%20and%20investor%20decision-making%20study%20FINAL.pdf>.

[20] The Strategic Counsel, *A Report to The Joint Standing Committee on Retail Investor Issues - Retail Investor Information Survey* (June 2009), online: <http://www.osc.gov.on.ca/static/_/JSC/jsc_retail-investor-info-survey.pdf>.

[21] *Ibid*.

[22] See also *supra* note 19, which came to similar results, at page 14.

- require the appropriate management of actual or potential conflicts of interest and therefore presents potential agency costs (i.e. investors need to expend resources to ensure their advisor is acting in their best interest, but have been demonstrated not to do so);
- align advisors' interests with those of their clients;
- facilitate informed consumer choice;
- require clear disclosure of the legal obligations of firms and advisors and therefore creates an expectations gap between consumers' expectations and financial service providers' legal obligations;
- require the clear presentation of the costs of investing to consumers prior to purchase;[23]
- explicitly require advisors to take costs into consideration in making an investment recommendation;
- regulate titles and credentials to ensure that they are meaningful and allow consumers to differentiate between different financial service providers and the different advice parameters available.

2.2. ***Regulations Permit Practices Harmful to Consumers***- The current Canadian securities regulatory regime:

- allows marketing and advertising materials to describe the services as being in the best interest of the client and induces the client to trust that the firm and the advisor will provide services in the client's best interest;
- allows fees to be embedded in the cost of the product and permits fee structures that are opaque, complex and difficult for consumers to understand;
- allows fees to be used by product manufacturers to incent financial service providers to sell higher-cost products that pay them higher commissions. This increases the fund's assets under management which increases the management fees payable. This creates a conflict of interest between the fund manufacturer and the fund's investors, since the mutual fund manufacturer rather than the fund or its investors is the primary beneficiary of the fund's asset growth;[24]
- undermines healthy competition, because product manufacturers compete for advisors' business, rather than investors';
- does not explicitly require the financial service provider to consider the cost of financial product when determining what is suitable for the client;
- allows "advisors" to recommend leverage (or borrowing to invest) in order to increase assets under management, which inappropriately increases risk for most investors; and
- more generally, undermines effective price competition.

2.3. ***Importance of Costs*** - **Costs are an important determinant of long-term returns from collective investments such as mutual funds.**[25] However, regulatory requirements in Canada do not

[23] FAIR Canada believes this to be a current expectation, but given that investors have difficulty accessing such information in lengthy, legalistic disclosure documents and that investor surveys demonstrate a very low awareness of costs, we do not believe the current system could be said to require clear information with respect to costs prior to purchase. We recognize that initiatives such as Point of Sale and CRM are underway and will eventually provide better cost information to consumers.

[24] (2012) 35 OSCB 11233 at page 11254.

[25] See the Securities and Exchange Commission's *Calculating Mutual Fund Fees and Expenses* (October 8, 2010), online: <http://www.sec.gov/investor/tools/mfcc/mfcc-int.htm>. See also John Bogle's comments in *Lower fees: Slice your way to a*

expressly require advisors to consider costs in determining the suitability of a given investment decision. The absence of a requirement to consider costs has provided an opportunity for advisors to sell high-fee products that benefit themselves and their firms at the expense of consumers.

2.4. In our opinion, cost should be an important element of the duty to deal "fairly, honestly and in good faith" but it does not appear to have been interpreted as such. FAIR Canada questions why costs have never been a mandatory consideration in the suitability assessment, particularly in light of the compelling evidence that demonstrates that Canadians pay excessively high fees for mutual funds and the impact that high costs has on the ability to save for one's retirement or other financial goals. The absence of a statutory best interest duty has likely contributed to the high fees Canadians pay.

2.5. ***Canada's Strong Banking System versus Non-Competitive Investment Industry*** - Opponents of a best interest duty often suggest that regulatory changes outside of Canada do not justify changing the rules in Canada because the Canadian financial system is fundamentally sound and has weathered the most recent economic crisis better than many other countries. While this may be true of Canada's banking system, we do not agree with respect to the business practices of the investment industry. Canada is a high-cost jurisdiction, in part as a result of its lack of competition on investment costs, but probably also in large part because of the absence of a statutory best interest duty. The Canadian investment industry is far less competitive and charges investors much higher fees than in the U.S. and most other developed countries. A lack of cost competition hurts financial consumers and may lead to systemic risk.

2.6. The existing regulatory requirements and industry practices do not provide adequate protection for consumers of financial services in Canada. Canadian investors continue to pay among the highest mutual fund fees in the world.[26] The lack of a statutory best interest duty, together with a lack of competition and opaque fee disclosure, are undoubtedly major contributing factors to Canada being a high-cost jurisdiction. The introduction of a statutory best interest duty for advisers and dealers would result in increased consumer protection for consumers, better financial outcomes for consumers[27], result in more effective competition, and increase the level of trust in the financial services market.

2.7. FAIR Canada urges the CSA to implement a statutory best interest duty as promptly as possible in order to create the market conditions where advisers and dealers must determine whether their high fee levels are in the best interests of their clients and to keep pace with leading jurisdictions.

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more fruitful portfolio (June 15, 2012) Globe and Mail online: <http://www.theglobeandmail.com/globe-investor/personal-finance/lower-fees-slice-your-way-to-a-more-fruitful-portfolio/article4280020/>.

[26] Benjamin N. Alpert and John Rekenthaler, *Morningstar Global Fund Investor Experience 2011* (March 2011), online: <http://corporate.morningstar.com/us/documents/ResearchPapers/GlobalFundInvestorExperience2011.pdf>.

[27] According Innovative Research Group, Inc., *2012 CSA Investor Index* (October 16, 2012), online: <http://www.securities-administrators.ca/uploadedFiles/General/pdfs/2012%20CSA%20Investor%20Index%20-%20Public%20Report%20FINAL_EN.pdf>, 55% of Canadians have investments outside a company-managed pension plan, RRSP or RRIF.

BENEFIT OF A BEST INTEREST DUTY:

The introduction of a statutory best interest standard for dealers and advisers would result in:

- increased protection for consumers;
- better financial outcomes for consumers;
- more effective competition;
- and increase in the level of professionalism in the financial services industry; and
- an increase in the level of trust in the financial services market.

RECOMMENDATION:

FAIR Canada recommends that the CSA implement a statutory best interest duty when advice is provided to retail clients as promptly as possible.

2.8. ***Conflicts of Interest*** - As the saying goes, "he who pays the piper calls the tune". Real and perceived conflicts of interest compromise the quality of investment recommendations. They misalign the interests of advisors, firms and their retail clients. Conflicts of interest may also diminish consumer confidence and increase the likelihood that clients will be taken advantage of and harmed. Bias toward an advisor's own interest can result in higher costs and less optimal recommendations to investors. **Investors have a very low awareness of (i) the existence of conflicts of interest[28], and (ii) the potential impact of conflicts of interest[29]. In addition, investors do not have the requisite knowledge to appropriately factor the impact of a conflict of interest into their evaluation of the advice they receive.**

2.9. ***Mutual Fund Fees Consultation*** - In FAIR Canada's view, a fulsome review of the efficacy of the current principle-based rules regarding conflicts of interest[30] would have been appropriate in the Consultation Paper. We recognize and appreciate that the CSA has identified and discussed the potential for conflicts of interest in mutual fund fees in its Discussion Paper regarding mutual fund fees.[31] While the impact of conflicts of interest arising out of the structure of mutual fund fees is an extremely important issue with respect to retail investors, particularly given the proportion of Canadian consumers with savings invested in mutual funds[32], it is FAIR Canada's view that misaligned incentives are pervasive more generally throughout the financial services sector.

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[28] *Supra* note 19; *supra* note 27; *supra* note 20; and Lori Bottrell and Ed Weinstein, *Focus Groups with Retail Investors on Investor Rights and Protection* (April 2011) (prepared for the Investor Advisory Panel of the Ontario Securities Commission), online: <http://www.osc.gov.on.ca/documents/en/Securities-Category1-Comments/com_20110427_11-765_ananda.pdf>.

[29] *Supra* note 19; *supra* note 20; *supra* note 28 (Bottrell and Weinstein).

[30] (2009) 32 OSCB (Supp-2) (July 17, 2009) at s. 13.

[31] (2012) 35 OSCB 11233 starting at page 11254.

[32] *Supra* note 27 at page 11.

2.10. **Appropriate management of conflicts of interest will be integral to ensuring that a registrant is able to fulfill their obligation to act in the client's best interest**. From our perspective, the current requirements[33] are woefully lacking given:

(i) how the rules are interpreted by some advisers and dealers in practice (as found by the CSA); and
(ii) the fundamental conflict of interest presented by third-party commissions paid by product manufacturers (out of investor assets or otherwise) or their agents.

2.11. ***Industry-Created Conflicts of Interest*** - Many industry participants acknowledge the potential for conflicts of interest between clients and advisors. "…our business, in and of itself, is inherently conflictual. …There is some inherent conflict because of compensation or products that we're are selling."[34] **We include this quote to illustrate what we believe to be a pervasive and almost subconscious acceptance in the industry (and seemingly by securities regulators) that there are serious, material conflicts of interest inherent in the advice-giving relationship**. **FAIR Canada suggests that the notion of an 'inherently conflictual' advisor-client relationship is a creation of industry and is not self-evident.** While industry greatly prefers the status quo, there is absolutely no reason to accept prima facie that many of the 'inherent' conflicts of interest present in the financial services industry could not be controlled and completely eliminated.

2.12. ***Leading Jurisdictions Do More*** - The U.K. and Australia have moved to prohibit embedded third party commissions in order to address conflicted remuneration structures present in these jurisdictions. The U.S. (which does not currently prohibit conflicted remuneration) regulates trailer commissions. There is no reason why Canadian regulators should afford financial consumers in Canada a lower level of protection.

2.13. ***G20 Principles*** - According to the G20 High-Level Principles on Financial Consumer Protection,

> Where the potential for conflicts of interest arise, financial services providers and authorised agents should endeavour to avoid such conflicts. When such conflicts cannot be avoided, financial services providers and authorised agents should ensure proper disclosure, have in place internal mechanisms to manage such conflicts, or decline to provide the product, advice or service.[35]

In FAIR Canada's view, the best way to avoid the conflicts of interest presented by third-party commissions is to prohibit them altogether.

2.14. Not only are direct, compensation-based conflicts of interest harmful to financial consumers, but we are also concerned that other, more systemic, conflicts drive less-that-optimal advice. For instance, performance targets for employees to maintain their employment or to earn bonuses drive sales based on the incentive to the salesperson (or firm) rather than the needs of the financial consumer. Performance incentives must be designed to motivate advice that is in the best interest of the client.

2.15. ***Disclosure Inadequate*** - International securities regulators have stated that, in order to address conflicts of interest, market intermediaries should: (1) avoid conflicts of interest (refrain) if the conflict is so great a management mechanism is unlikely to protect the interests of a client; and

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[33] (2009) 32 OSCB (Supp-2) Companion Policy 31-103CP *Registration Requirements and Exemptions* at s. 13.4. The requirement is merely to disclose any identified conflicts of interest "if a reasonable investor would expect to be informed".

[34] Joe Bajic, CCO Assante Capital Management Ltd. at IIROC CRM Symposium Panel Discussion "Management and Disclosure of Conflicts of Interest" (June 2012) starting at approximately minute 14:30.

[35] *Supra* note 14 at page 7.

(2) appropriately manage other conflicts of interest (through information barriers, dealing restrictions, and/or disclosure.[36] **In our view, a disclosure-based approach to managing conflicts of interest is not compatible with a best interest standard. FAIR Canada recommends that any firm or individual subject to a best interest standard be, at a minimum, precluded from accepting conflicted remuneration.**

2.16. **We suggest that advice would be more likely to be provided in the best interest of the client if there was a ban on conflicted remuneration as this would eliminate many sources of conflicts of interest in the advisory relationship.**

2.17. **Other jurisdictions have determined that disclosure is an ineffective approach to managing conflicts of interest.** For example, an Australian inquiry into financial products and services found:

> A significant conflict of interest for financial advisers occurs when they are remunerated by product manufacturers for a client acting on a recommendation to invest in their financial product… These payments place financial advisers in the role of both broker and expert adviser, with the potentially competing objectives of maximising remuneration via product sales and providing professional, strategic financial advice that serves clients' interests. The committee received considerable evidence on the nature and effect of these conflicts, including on the quality and cost of advice, and whether it is possible for them to be managed appropriately…
>
> Evidence to the committee strongly suggested that the current disclosure requirements had not been an effective tool for managing conflicts of interest.[37]

2.18. ***Perverse Effects of Disclosure*** - **A considerable amount of research has been conducted regarding the effects of disclosure, both within the financial services context and more broadly. These behavioural studies have proven the perverse effects of disclosing conflicts of interest**. As summed up in the abstract to "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest":

> Conflicts of interest can lead experts to give biased and corrupt advice. Although disclosure is often proposed as a potential solution to these problems, we show that it can have perverse effects. First, people generally do not discount advice from biased advisors as much as they should, even when advisors' conflicts of interest are disclosed. Second, disclosure can increase the bias in advice because it leads advisors to feel morally licensed and strategically encouraged to exaggerate their advice even further. As a result, disclosure may fail to solve the problems created by conflicts of interest and may sometimes even make matters worse.[38]

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[36] International Organization of Securities Commissions, *Market Intermediary Management of Conflicts that Arise in Securities Offerings – Final Report* (November 2007), online: <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD257.pdf> at page 10. According to IOSCO's Objectives and Principles of Securities Regulation (May 2003), online: <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf> "A firm should try to avoid any conflict of interest arising but, where the potential for conflicts arise, should ensure fair treatment of all its customers by proper disclosure, internal rules of confidentiality or declining to act where conflict cannot be avoided. **A firm should not place its interests above those of its customers**." [emphasis added]

[37] Parliamentary Joint Committee on Corporations and Financial Services (Australia), *Inquiry into financial products and services in Australia* (November 2009), online: <http://www.aph.gov.au/Parliamentary_Business/Committees/Senate_Committees?url=corporations_ctte/completed_inquiries/2008-10/fps/report/index.htm> at paras. 5.29-5.30 and 5.53.

[38] Daylian M. Cain, George Loewenstein, and Don A. Moore, "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest" (2005) 34(1) J. Legal Stud. 1.

2.19. ***Consumers Ill-Equipped***- Further, the research suggests that disclosure would be more effective when recipients of advice have expertise or experience to help them assess the potential effects of the disclosed conflicts of interest.[39] This is telling about the usefulness of such disclosure to unsophisticated recipients, such as individual retail investors, who are in the greatest need of protection.

2.20. "For disclosure to be effective, the recipient of advice must understand how the conflict of interest has influenced the advisor and must be able to correct for that biasing influence."[40] In our view, most investors do not have the requisite knowledge and experience to sufficiently adjust for the conflict of interest that is disclosed.[41]

2.21. This international research is bolstered by evidence that Canadian investors "believed that their advisor would look out for their best interest regardless of how the advisor was paid."[42] **Numerous surveys of Canadian financial consumers demonstrate a blind trust in financial advisors and a near-complete disregard for any effect that a conflict of interest may have on the advice provided.**

2.22. FAIR Canada recognizes that industry and regulators prefer the disclosure approach to managing conflicts of interest in an 'inherently conflictual' industry because it generally involves little disruption to the status quo (i.e. it does not necessitate a re-evaluation of business models and therefore is easier for regulators given industry opposition to reforms). Also, as noted in "The Dirt on Coming Clean", "[d]isclosure offers a further benefit to both advisors and to policy makers: it diminishes both parties' responsibility for adverse outcomes."[43] Further, while we are concerned about overt bias, "…considerable research suggests that bias is more frequently the result of motivational processes that are unintentional and unconscious."[44]

2.23. ***Third Party Commissions*** - **FAIR Canada believes that the best way to protect consumers from conflicts of interest arising in the advisor-client context is to ban conflicted remuneration. In particular, third party commissions should be prohibited.** In our view, third party commissions contribute significantly to the opaqueness of cost information and provide few, if any, tangible investor benefits. In theory they are based on the presumption that such commissions pay for "ongoing" advice to the investor, but FAIR Canada questions whether such advice is provided, and, where it is, how valuable it is to the consumer. **Third party commissions inhibit healthy competition, in that they encourage anti-competitive behaviour between issuers (or their agents) to pay higher commissions to a sales force in order to sell more of their product. Instead of issuers competing on the basis of lowest costs to consumers, they compete to win the business of advisors, thus driving up the costs of investing to unsophisticated consumers.**

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[39] *Ibid*. at page 20.
[40] *Supra* note 38 at page 3.
[41] This is as a result of the combination of (1) a lack of awareness of conflicts of interest and (2) the low overall investment knowledge of Canadians. The *CSA 2012 Investor Index* (see *supra* note 27) found a low awareness of how Canadians' financial advisors are compensated and that "…overall investment knowledge of Canadians is low, with 40 percent of Canadians failing a general investment knowledge test."
[42] *Supra* note 19.
[43] *Supra* note 38 at page 3.
[44] *Supra* note 38 at page 5.

RECOMMENDATION:

Regulators must consider, either within the best interest initiative or through a separate consultation, whether embedded commissions are compatible with the best interest duty which we have recommended. FAIR Canada has great difficulty in understanding how an adviser or dealer required to act in the client's best interest can accept payments from a third party which itself has a duty to investors. A best interest standard should include a prohibition against the acceptance of embedded commissions. In order to be independent, advisors should be paid by the consumers they serve.

2.24. ***Advisors' Lack of Objectivity May Not be Intentional*** - Even those advisors who want to provide advice that is in the best interest of their clients are deterred from doing so as a result of the compensation structure in place. Often, the effects on investors are unintended by advisors.

> Well-meaning professionals often think that they are being objective when in fact their advice partly services their own interest. If the public better appreciated this fact, perhaps disclosure would serve as a better warning. As it stands, most audiences think that their advisers would never intentionally mislead them, conflict or no conflict. Even if this were true, bad advice can be given unintentionally: good intentions do not ensure good advice.[45]

According to opinion leaders in the securities industry and related professions,

> [t]he industry sees itself in the midst of transforming from a sales culture to one of professional advice… There is a strong sense that the industry has to move towards more advice and planning to meet client needs and expectations… Transaction-driven compensation has the potential to distort the advice that advisors offer their clients.[46]

2.25. Prohibiting conflicted remuneration would improve outcomes for investors by:

(i) reducing compensation bias in recommendations;
(ii) reducing costs to investors through enhanced competition;
(iii) avoiding unintended consequences of disclosure, such as increased trust and reliance and moral license by the advisor; and
(iv) reducing the distribution of inferior products which are sold through the payment of higher-than-average fees.[47]

2.26. Furthermore, reducing conflicts of interest will require issuers and their distributors to focus on the quality of their products. We expect that banning conflicted remuneration would "weed out" the less-convincing products. A compensation system that was designed to be product-neutral would reduce conflicts of interest and provide better advice for financial consumers. This would enhance the professionalism of the financial services industry and enhance public trust in the industry.

[45] Paavan Gami, "Conflict of interest disclosure 'no panacea'" (February 21, 2012), Yale Daily News, quoting Dr. Daylian Cain, available online: <http://yaledailynews.com/blog/2012/02/21/conflict-of-interest-disclosure-no-panacea/>.
[46] Edward L. Weinstein and Lori Bottrell, *Bridging Business and Academia: Long-Term Issues in Client-Advisor Relationships and How to Address Them with Academic Research* (October 5, 2011), at page 6.
[47] Portus is one example of high fees motivating a sales force to sell poor products.

BENEFIT OF A BEST INTEREST DUTY:

A best interest duty, together with a ban on conflicted remuneration, would reduce bias in recommendations, thus making recommendations more objective. It will also eliminate much of the need for conflicts disclosure, which has been demonstrated not to work and to cause unintended negative consequences for investors.

It would also enhance the professionalism of the financial services industry and enhance public trust in the industry.

2.27. ***Agency Costs*** - Agency costs arise as a result of inefficiencies due to conflicts of interest. They may arise as a result of products that are less ideal because they are more costly or otherwise less-suited for the investors needs. They also arise where investors, who are aware of conflicts, are required to perform an analysis of how the conflict impacts the advice; not only are most investors ill-equipped to perform such an analysis (as discussed above), but this is inefficient because it requires investors to expend time and energy adjusting their reliance on the advice

2.28. ***Impact of Costs on Outcomes*** - While it is difficult to empirically estimate the impact of agency costs on investors, numerous reports have demonstrated the staggering impact of small differences in annual percentage costs to investors over the long term. **When the time value of money is factored in, even seemingly innocuous differences in investor costs can have a huge impact on investors' long term savings.**[48] For example, a study examining the consequences of higher fees demonstrated that a 1.1 percent increase in the effective expense ratio resulted in a decrease in savings of $156,000 based on an annual contribution of $10,000 per year for 40 years.[49] The investor would have had an additional 28 percent total savings had their investment expense ratio been 1.1 percent lower.

2.29. When conflicted remuneration results in advice that is not objective, whether intentional or unintentional, agency costs increase investors' cost of advice.

BENEFIT OF A BEST INTEREST DUTY:

A ban on conflicted remuneration would reduce investors' agency costs, which arise as a result of conflicts of interest, and which have a huge negative impact on consumer's long-term savings. In particular, financial consumers would no longer need to analyze recommendations from financial advisors for conflicts of interest, which research has demonstrated they are ill-equipped to do.

[48] See, for example, http://www.milliondollarjourney.com/the-longterm-cost-of-higher-management-expense-ratios-mers.htm; http://www.which.co.uk/money/savings-and-investments/guides/different-types-of-investment/are-fund-charges-eating-into-your-returns/; and http://www.steadyhand.com/education/fees/.

[49] Keith Ambachtsheer and Rob Bauer, "Losing Ground – Do Canadian mutual funds produce fair value for their customers?"(Spring 2007), Canadian Investment Review 8, contents available online: <http://arno.uvt.nl/show.cgi?fid=81991 > at page 12. This article summarized the findings of the study titled "Economies of Scale, Lack of Skill, or Misalignment of Interest? A Study of Pension and Mutual Fund Performance" by Bauer, Frehen, Lum, and Otten.

2.30. ***Inhibits Informed Consumer Choice*** - Many investment service providers pass themselves off as acting in a client's best interest when in fact they do not and are not legally obliged to do so. This disadvantages other advisors who do meet a best interest standard in their daily activities but are unable to differentiate their services to potential clients.

> In equilibrium, naive customers underestimate the likelihood with which they end up purchasing [a product] that generates higher profits for the respective financial institutions and for the intermediary than a more basic offering (or no purchase). Even though customers appear not to pay for advice, in reality they are thus seriously shortchanged through biased advice and higher product prices, in the form of higher management fees on investment products... **With naive customers, there is a clear benefit of policy intervention that requires firms to make customers pay directly for advice**… In fact, in the absence of policy intervention, **when the market is populated mostly by naive customers, firms could generate higher profits by targeting exclusively naive customers rather than serving the whole market with a non-exploitative offer**.[50] [emphasis added]

2.31. While some evidence suggests that investors indicate a preference for paying through embedded commissions[51], FAIR Canada believes that public policy should provide for informed consumer choice and healthy competition. **Ensuring investors to know what they pay for their investments and, importantly, how much they pay for advice would support financial consumers in performing a true evaluation of the value of advice and would encourage competition to provide good value for consumers of financial products.**

2.32. ***Commission Models Confusing*** - Fund Facts document research (specific to mutual fund and segregated fund information) found an interesting reaction from advisors with respect to commission language proposed for the Fund Facts document. "Advisers argued that commission practices across Canada vary so widely that it is hard to explain them clearly and succinctly to investors."[52] We question how investors could be expected to make informed decisions if commission practices are so difficult to explain.

2.33. ***Conflicted Remuneration Drives Recommendations*** - Research based on U.S. data confirms our expectation that advisor incentives impact investment decisions. Specifically, the research found that "...brokers' incentives play a significant role in both flows and performance"[53] where new investment increases with the load paid to the broker and future performance decreases with the broker's payment from the load. Specifically, the paper found that "[r]evenue sharing also

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[50] Roman Inderst and Marco Ottaviani, "How (not) to pay for advice: A framework for consumer financial protection" (August 2011), online: <http://www.wiwi.uni-frankfurt.de/fileadmin/user_upload/dateien_abteilungen/abt_fin/Dokumente/PDFs/Allgemeine_Dokumente/Inderst_Downloads/Finance/How_not_to_pay_for_advice.pdf > at page 4. Note that in this paper, "naïve" investors were those who "fail to adequately take into account the potentially self-interested nature of advice". In FAIR Canada's view, based on the extensive investor surveys referred to elsewhere in this submission, this would describe a [majority] of Canadian investors.

[51] See, for example, Pollara Inc., "Canadian Investors' Perceptions of Mutual Funds and the Mutual Fund Industry" (2011) (prepared for the Investment Funds Institute of Canada), online: <https://www.ific.ca/Content/Document.aspx?id=6842>. FAIR Canada questions some of the conclusions drawn from this research.

[52] Research Strategy Group, "Fund Facts Document Research Report" (October 25, 2006) (prepared for the Ontario Securities Commission), online: <http://www.sfsc.gov.sk.ca/adx/aspx/adxGetMedia.aspx?DocID=2382,2288,257,105,81,1,Documents&MediaID=3523&Filename=81-406-appendix5-june15-07.pdf > at page 47.

[53] Susan E.K. Christoffersen, Richard Evans, and David K. Musto, "What do consumers' fund flows maximize? Evidence from their brokers' incentives" (March 8, 2012), online: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1393289> at page 4.

increases new investment…"[54] The paper also cites numerous other literature on 12b-1 fees (distribution and service fees charged by mutual funds in the U.S., including fees for marketing and compensation for brokers, which are charges included in the MER in Canada), "which have been shown to relate positively to net flows"[55]. Advisor incentives can therefore negatively impact consumer outcomes.

2.34. ***The "Value" of Advice*** - While many who profit from the advisor-client relationship tout the "value of advice"[56], FAIR Canada is concerned that a positive correlation between "advice" (which is undefined in the reports prepared by the investment fund industry lobby group IFIC) and positive outcomes (which are vague in the reports, and consist primarily of increased savings levels) is interpreted to demonstrate that "advice positively and significantly affects the level of savings of individuals…" We note that a correlation does not necessarily prove cause and effect. We also note that the "advice" that most people are sold consists of recommendations as to which investments to purchase, not how to save. While increased savings may be a positive by-product of good investment advice, the reports do not demonstrate that advice adds value for consumers.

2.35. Industry lobby groups' interpretations, however, are trumpeted to demonstrate the value of "advice". In fact, one of the authors of the study said: "We need a better study and a better paper before I would be comfortable with the way they are saying what they are saying." He indicated that the study "is absolutely refutable given the limitations of the data."[57]

2.36. ***Value for Money*** - Further, we note that these "reports" do not evaluate the cost of advice, and therefore do not provide any determination of whether the 'value' of advice exceeds the cost of advice. The benefits of services are typically assessed in relation to the costs.

2.37. ***Lower-Cost Ways to Enhance Savings*** - While the studies are not determinative, even if "advice" prompted individuals to save more, and thus improved economic outcomes, FAIR Canada suggests that there may be other less-costly policies that could be implemented that would have the same (or greater) effect. For example, lower-cost options, such as a supplementary Canada Pension Plan or enhancing the Canada Pension Plan, or low-cost Pooled Retirement Pension Plans could be designed to ensure that participation is the default option for employers and employees who are not members of employment-based pension plans.

2.38. ***Conflicted Studies*** - Often "studies" put forward by members of the financial industry attempt to prove value by surveys of investors' belief that their advisor provides them with value. However, these studies fail to control for awareness of the true costs of advice. There is no evidence that, when investors are asked whether they get value for the advice they are provided, they are aware of what they paid for that advice over any given period of time. Further, studies demonstrate that, while some investors understand basic investing concepts, even those who do understand the risk-return relationship or the concept of compound interest (for example) the

[54] *Ibid*. at page 4.
[55] *Supra* note 53 at page 8.
[56] See, for example, IFIC's annual "The Value of Advice: Report" (2012), online: <https://www.ific.ca/Content/Document.aspx?id=7506>. See also industry interpretation of the following study: Claude Montmarquette and Nathalie Viennot-Briot, "Econometric Models on the Value of Advice of a Financial Advisor" (July 2012), online: <http://www.cirano.qc.ca/pdf/publication/2012RP-17.pdf>.
[57] See Preet Banerjee, "Financial industry overselling value of financial advice" (November 25, 2012), online: <http://www.theglobeandmail.com/globe-investor/personal-finance/household-finances/financial-industry-overselling-value-of-financial-advice/article5360796/>.

majority of investors lack the means to apply these concepts to basic investment decisions.[58] As a result, FAIR Canada questions the inferences that client satisfaction equals value for the cost paid.

2.39. ***Lack of Industry Faith in Value of Advice*** - If the majority of the industry truly believed that consumers were this confident that they are getting value for their money, why is there such strong opposition to the disclosure of costs and such stalwart opposition to the prospect of requiring investors to pay for advice directly? Given the low level of trust in the investment industry as a whole[59], it would make sense to eliminate sources of distrust in the industry.

BENEFIT OF A BEST INTEREST DUTY:

A ban on conflicted remuneration would facilitate more informed consumer choice about the purchase of advice.

We expect that encouraging investors to look more critically at what they are getting for what they pay will improve competition, and that economic forces will spur innovation in the delivery of cost-effective advice that meets a best interest standard.

2.40. ***Regulation Required for Efficiency*** - Regulatory intervention is necessary to address the pressing investor protection concerns outlined in the CSA's Consultation Paper.[60] According to the SEC, "[t]he regulatory regime that governs the provision of investment advice to retail investors is essential to assuring the integrity of that advice and to matching legal obligations with the expectations and needs of investors."[61]

2.41. The current system is inefficient and often leads to poor consumer outcomes as a result of the following:

- investors are unable to make informed decisions regarding the purchase of "advice";
- investors pay for ongoing advice even if they do not receive ongoing advice;
- investors may pay for 'advice' from financial services firms that are prohibited from providing advice (i.e. discount brokerages are not permitted to provide advice but still receive some trailing commissions as advisors)[62];

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[58] The Brondesbury Group, *Benchmarking Investor Knowledge* (2011) (prepared for the Investor Education Fund), online: <http://www.getsmarteraboutmoney.ca/en/research/Our-research/Documents/Rpt_InvKnowl_Abridged_final%202011.pdf>. The CSA 2012 Investor Index (*supra* note 27) reported that "overall investment knowledge of Canadians is low, with 40 percent of Canadians failing a general investment knowledge test."

[59] Advisor Impact, *Economics of Loyalty 2012: Summary Report* (2012), online: <http://www.iiac.ca/resources/5693/advisor%20impact%20survey%20report%20-%20economics%20of%20loyalty%202012_canada.pdf> at page 32.

[60] (2012) 35 OSCB 9558 at 9579 to 9582.

[61] Securities and Exchange Commission (Staff), *Study on Investment Advisers and Broker-Dealers – As Required by Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (January 2011), online: <http://www.sec.gov/news/studies/2011/913studyfinal.pdf> at page i of Executive Summary.

[62] See IIROC Dealer Member Rule 3200 (3)(a). Discount brokers are required to disclose at account opening that they are not permitted to provide any recommendations to the customer, that the customer alone is responsible for his or her own investment decisions and the dealer will not consider the customer's financial situation, investment knowledge, investment objectives and risk tolerance when accepting orders from the customer.

- there is a dearth of information available to evaluate the value of the services they receive and the costs they pay;
- true competition is inhibited by conflicted remuneration, commissions structures, and other compensation incentives practices (particularly third party commissions);
- there is limited incentive for advisors to provide cost-efficient advisory services (because investors have been lead to believe that advice is free and that all advisors act in their best interest); and
- the spectrum of advisor proficiency is wide and consumers do not receive any guidance as to a particular advisor's proficiency. Inflated titles and confusing credentials that are incomprehensible to consumers are a big part of this problem.

2.42. ***Low Financial Literacy*** **-** Financial literacy is low in Canada.[63] The 2012 CSA Investor Index found that "…2-in-5 Canadians failed the general investment knowledge test included in the survey, answering fewer than four of the seven questions correctly."[64] Further, evidence suggests that "…[e]ven when people understand a financial or economic principle in theory, applying the principle to a real situation is difficult for them."[65] A survey by the Investor Education Fund found that only three out of ten Ontarians meet a 60% notional passing grade when it comes to investor knowledge.[66] Even if financial literacy were higher, product complexity makes it difficult for the average Canadian to adequately inform themselves about a spectrum of different products. This is the reason they retain an advisor and rely on the advice they receive. As noted in the Consultation Paper, poor financial literacy is not unique to Canada.[67]

2.43. ***Expectations Gap*** **-** Investors do not know firms' legal obligations[68] and firms and advisors benefit from opaqueness. As noted in the Consultation Paper, "these expectations of investors are often created and reinforced by the advertising and promotional statements made by some advisors and dealers."[69] Regulatory obligations (including suitability) are so complex that even industry professionals have difficulty understanding them; it is not reasonable to expect consumers to understand the obligations they are owed.

2.44. ***Informational Asymmetry*** **- The need for a best interest duty arises as a result of the specialized knowledge and specific skills and abilities that the advisor has and the trust and reliance that investors place on the advice they receive.** Suitability is too low a standard, as it only requires the determination of "whether an investment is appropriate" and "whether the product and client are a match"[70]. Consumers expect more than this from investment advice, and believe they get more. Further, the current suitability standard does not expressly require costs to be factored into the suitability assessment. Investors would benefit from the identification of a smaller range of products (than the range that would be suitable) that are in the client's best interest, including giving consideration to the cost to the client of such products.

2.45. ***Align Reality with Expectations*** - The expectations of financial consumers and advisors must be aligned in order for securities regulation to truly provide an adequate level of investor protection. In FAIR Canada's view, it would be more beneficial for both financial consumers and

[63] *Supra* note 60.
[64] *Supra* note 27 at page 38.
[65] *Supra* note 58 at page iii.
[66] *Supra* note 58 at page 16.
[67] *Supra* note 60 at 9580.
[68] *Supra* note 19; *supra* note 28 (Bottrell and Weinstein).
[69] *Supra* note 60 at page 9581.
[70] *Supra* note 60 at page 9567, footnote 45.

advisors to raise the standard than to prohibit the industry from making any representation about acting in the clients' best interest, given the realities described above.

BENEFIT OF A BEST INTEREST DUTY:

A best interest duty will improve consumers' trust in the financial services industry, as obligations will meet financial consumers' expectations. Further, it will assist the financial advice industry in its ambition to be recognized as a profession.

2.46. ***Reforming Opaque Costs of Investing*** - FAIR Canada commends the CSA for moving forward with initiatives such as the Fund Facts document and cost disclosure and performance reporting requirements. These initiatives will go a long way to providing better information to investors about the costs of their investments.

2.47. FAIR Canada does not believe that these initiatives, on their own, can fully ameliorate the problems identified in the CSA's Consultation Paper or described above by FAIR Canada. While we believe that full information should absolutely be provided to investors, these documents do not address conflicts of interest or the full trust and reliance consumers place in and on their advisors. Investor protection problems arising as a result of the nature of the relationship between financial consumers and advisors, increasingly complex financial products that many consumers do not have the financial literacy to understand, along with the advertising and marketing materials intended to induce complete trust and confidence cannot be addressed through better disclosure of costs. A best interest duty is imperative.

BENEFIT OF A BEST INTEREST DUTY:

A best interest duty will improve outcomes for consumers because it will ensure the most efficient allocation of responsibilities between the advisor and the consumer given the level of financial literacy of consumers, the degree of knowledge and specialized skills and abilities that the advisor needs to possess, and the complexity of financial products.

2.48. ***Costs Are Not an Explicit Requirement Under Suitability*** - While we believe that costs should be a consideration under the current requirements for advice, it is clear that the cost of the product to the consumer is not always factored into recommendations. The suitability standard is too low; suitability is too wide a spectrum and does not necessarily require costs to be considered.

2.49. Making the consideration of costs an explicit requirement in the provision of investment advice will result in better outcomes for many financial consumers. As noted in the Consultation Paper, "[t]his may have the effect of investors acquiring an appropriate investment at a lower price or acquiring a better investment at the same price."[71]

[71] *Supra* note 60 at 9585.

BENEFIT OF A BEST INTEREST DUTY:

A best interest duty will improve outcomes for consumers because it will explicitly require registrants to consider the investment costs in determining whether the investment is in the best interest of the consumer.

3. Articulation of the Statutory Best Interest Standard

3.1. ***Application to Advice*** **- The CSA has set out one possible articulation of a statutory best interest standard. FAIR Canada supports a standard of conduct which requires that all firms and their financial service providers must act in the best interests of the client when providing advice to a retail client.** FAIR Canada believes that advice should be interpreted to include all advice as to investing including advice not to purchase or sell securities as described in section 9.6 below.

3.1. **FAIR Canada supports the requirement to act in the client's best interest rather than a fiduciary duty.** A statutory best interest duty would not require that an investor must prove all five of the indicia of a fiduciary relationship nor would it import those indicia into the statutory best interest standard. A best interest standard for the relationship between the financial service provider and client is needed given the spectrum of relationships that exist between the financial service provider and consumers. We strongly believe that, in order to have good outcomes for consumers, advisers, dealers and their financial service providers should be required to act in their clients' best interest.

3.2. **Applying a statutory best interest standard will significantly reduce, if not eliminate, any confusion (for consumers as well as advisers and dealers) about whether a fiduciary duty or duty to act in the best interest of the client applies in a given situation. The best interest standard will apply in respect of all financial service provider-client relationships.**

RECOMMENDATION:

A statutory best interest standard should apply to any advice or recommendation provided in relation to securities, including recommendations or advice not to purchase or sell securities.

3.3. ***The Standard of Conduct*** **- In order to act in the client's best interest when providing advice to a client, the firm and its financial service providers should be required *to act honestly*, and *owe a duty of loyalty or duty of utmost good faith* to the client.** These attributes of the statutory standard of conduct need to be articulated in the statutory definition to ensure that the client's interests are paramount and that conflicts of interest are avoided, including avoiding remuneration structures for financial service providers and their agents which result in conflicts (or misaligned incentives).

RECOMMENDATION:

The best interest standard must include a duty to act honestly and to owe a duty of loyalty or duty of utmost good faith to the consumer.

3.4. ***The Standard of Care*** **- FAIR Canada agrees that that the standard of care should be that the financial firm and its financial service providers should perform their services with the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances, and we would add *"having regard to the special knowledge or experience that that it is reasonable to expect of a person acting in that type of financial services business and having regard to any special knowledge or experience that the person holds himself or herself out as having*." In other words, one should be required to perform services at a level commensurate with one's professed level of knowledge and expertise.**

3.5. The duty of care is the same regardless of whether the client is wealthy or of modest income and has modest assets. Some have argued that the lower the client's sophistication, the higher the duty of care, so lower asset-clients would cost advisors more to serve, while increasing the exposure to liability. The Investment Industry Association of Canada ("**IIAC**") has stated:

> Advisors may refuse to accept new or lower wealth clients based on increased liability risks. In general, the lower the client's sophistication, the higher the duty of care imposed under a fiduciary standard. Therefore, smaller, less sophisticated asset clients could cost advisors more money to serve, while increasing their exposure to liability as damages tend to be greater under a fiduciary standard.[72]

3.6. FAIR Canada disagrees with the IIAC's proposition for the reasons articulated below. Firstly, it is not the case that consumers who are more wealthy are thereby more sophisticated. There are many consumers with significant assets who have low financial literacy and rely on the financial service provider to provide them with recommendations that are in their best interest. The 2012 CSA Investor Index found that 21% of investors with annual household income over $100,000 had low investment knowledge, while 35% had medium knowledge.[73]

3.7. Secondly, FAIR Canada does not agree that a higher duty of care is imposed with respect to consumers with lower sophistication. The duty of care that will be statutorily defined should be the same regardless of the degree of knowledge or sophistication of the client. The duty of the "advisor" to perform their services with the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances, having regard to the special knowledge or experience that that it is reasonable to expect of a person acting in that type of financial services business and having regard to any special knowledge or experience that the person holds himself or herself out as having, is the same regardless of the characteristics of the client. **The same duty of care to obtain the necessary information from the consumer about their risk tolerance, investment needs, and objectives and loss capacity, etc. applies. Similar to the situation of a director's duty of care to the corporation[74], where the duty does not vary depending on the type of corporation or the type of shareholders who hold shares in the corporation, the duty will not vary depending on the wealth or sophistication of the consumer.**

[72] Investment Industry Association of Canada, "IIAC Examination of Implications of a Fiduciary Standard" (June 20, 2012), at page 3.
[73] *Supra* note 27 at page 40.
[74] See for example, section 134 of the Ontario *Business Corporations Act*, R.S.O. 1990, c. B.16.

3.8. In fact, it could be argued that it is easier and less complicated to discharge one's obligations in respect of a person who only has $100,000 or less to invest, than it is to provide advice for a person who has $2 million to invest. The potential liability (in amount) and complexity of the client's investment needs is arguably greater for the latter type of client than the former.

3.9. While the steps to meet the duty may vary depending on the circumstances of the particular case, FAIR Canada believes that the same duty applies. We are aware of the *Abrams v. Sprott Securities*[75] decision, in which the judge commented that the standard will vary depending on the experience and skills of the client. However, we note that the case was decided in the absence of a statutory duty of care and was also decided under negligence. In addition, steps to fulfill the duty can be articulated in guidance should that be necessary.[76]

RECOMMENDATION:

The standard of care should be that the adviser, dealer and financial service provider will perform their services with the degree of care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances, having regard to the special knowledge or experience that it is reasonable to expect of a person acting in that type of financial services business and having regard to any special knowledge or experience that the person holds himself or herself out as having.

The duty of care will be the same regardless of the sophistication of the client, but the steps taken to meet the duty will vary depending on the circumstances of the particular case.

3.10. ***To Whom Is the Duty Owed? -*** The duty should apply to all natural persons using advice for personal, family or household reasons and also apply to any personal holding corporation vehicles.

3.11. In FAIR Canada's view, this would thereby encompass all retail investors regardless of their level of wealth and sophistication. We realize that clients beyond a certain level of wealth (i.e. Permitted Clients) are treated differently in existing areas of securities law and, therefore, provincial securities regulators may wish to re-examine this in principle when implementing a best interest standard.

RECOMMENDATION:

The duty is owed to all natural persons receiving advice for personal, family or household reasons and also for advice regarding investments held through personal holding corporation vehicles.

[75] *Abrams v. Sprott Securities Ltd.*, 2003 177 OCA 148, 67 OR (3d) 368 (O.N.C.A.).

[76] See for example *Corporations Amendment (Further Future of Financial Advice Measures) Act 2011* (Australia) s. 961B(2) and Regulatory Guide 175 "Licensing: Financial product advisers – Conduct and disclosure" (December 2012), online: <http://www.asic.gov.au/asic/pdflib.nsf/LookupByFileName/rg-175-published-13-December-2012.pdf/$file/rg-175-published-13-December-2012.pdf> at pages 84 to 86.

4. Assessment of the Statutory Standard

4.1. Consideration should be given as to how one will assess whether the advice provided, **at the time it was given (rather than in hindsight)**, was in the best interest of the financial consumer. Similar to other areas such as the discharge of directors' and officers' duties of care, **a court or arbiter is not to substitute their own decision for that of the financial service provider, as long as the latter's exercise of judgement was reasonable, sound or prudent in the circumstances.**

4.2. The assessment of whether the advice was in the best interest of the client, as discussed above, will be composed of many factors, including the cost of the investment. FAIR Canada disagrees with the Investment Funds Institute of Canada ("**IFIC**") that "...investors should remain focused on what is the best investment for them, rather than rejecting good investment recommendations simply because of how much their advisors would be paid".[77] This is fundamentally misguided for a number of reasons including:

a. The best investment recommendations are not always made since often the advisor is told by his or her firm which investments to recommend and is incented by certain mutual fund or other product providers to sell their products over others by the prospect of higher remuneration.
b. Most clients are currently unaware of how the financial service provider is getting paid.
c. Disclosure of the amount the advisor is getting paid, if it is disclosed, typically does not lead the investor to reconsider the recommendation, given the perverse behavioural effects of disclosure, as discussed above.
d. The determination of the best investment recommendation must include a consideration of the costs which will be incurred, as the ultimate return to the investor from their investment will depend on how much they pay in costs and fees.

4.3. Starting with sound principles upon which to base the advisor-client relationship, along with the articulation of the best interest standard as described above, should result in much more clarity for investors as well as firms and their advisors as to obligations and responsibilities and result in an efficient allocation of those obligations and responsibilities.

4.4. FAIR Canada considers that as part of meeting a best interest standard the financial service provider would provide clear, meaningful (and comprehensible) disclosure of the nature of the relationship, including: the scope of the services they will provide; the costs that will be incurred by the client; and whether there are any limitations on the scope of the products that the financial service provider is able to sell (as a result of registration restrictions, or as a result of the firm's approved product list). **Such disclosure will specify the nature of the services and duty that attaches to those service but should not be permitted to limit the statutory best interest duties that will otherwise apply to the services offered.**

5. Scope of Products Offered by Firm and its Financial Service Provider

5.1. ***Registrants Limited to Certain Products*** - If the firm and its advisors are limited in the products that they sell (for example, only registered to sell mutual funds) then the advisor must

[77] Investment Funds Institute of Canada, *Fiduciary Duties and Financial Advisors – Frequently Asked Questions and Answers* (July 1, 2011) online: <https://www.ific.ca/Content/Document.aspx?id=6975>.

investigate and consider products outside their registration to ensure that they have acted in the best interest of the client. If the advisor is unable to recommend a product due to its being outside the scope of their registration, but such product would be in the client's best interest, the advisor must inform the consumer of the type of products that the client should investigate further, and advise the client which type of financial service firms it can be obtained through (with or without "advice"; for example, through a discount brokerage).

5.2. ***Greater Scope for Mutual Fund Dealers*** - If the firm is restricted in its product list, such as with mutual fund dealers, **consideration should be given to permit registrants of such dealers to become registered to sell other collective investment products such as exchange traded funds (ETFs), provided they meet the necessarily level of proficiency, so that the list of products that they are permitted to sell more easily allows them to discharge their obligation to provide advice in the best interest of the client.** If mutual fund dealers are able to sell ETFs and other collective investment products, they will be able to offer a wider spectrum of financial products that will meet the needs of many more consumers. We have been advised by the MFDA that 38 percent of the financial industry's mutual fund assets under management are currently held by MFDA members, who are currently not able to sell other collective investment products such as exchange traded funds (ETFs) but may be licensed to sell segregated funds under a separate insurance license.

RECOMMENDATION:

If the firm and its advisors are limited in the products that they sell (for example, only registered to sell mutual funds) then the advisor must investigate and consider products outside their registration to show that they have acted in the best interest of the client. If the advisor is unable to recommend a product due to its being outside the scope of their registration, but such product would be in the client's best interest, the advisor must inform the consumer of the type of products that the client should investigate further, and advise the client which type of financial service firms it can be obtained through (with or without "advice"; for example, through a discount brokerage).

"Independent Advice" from Advisors versus "Restricted Advice" from Salespeople

5.3. ***Two Tiers Alternative*** - **FAIR Canada believes that all investment advice should be subject to a best interest duty.** However, we understand that given the structure of the industry, some current business models will need to be modified significantly in order to be economically viable under a best interest standard. If regulators are not willing to impose a best interest standard on all existing business models, FAIR Canada recommends that regulators take a phased approach, and those who would need to modify their business model in order to meet a best interest duty to consumers (where they would have a wide enough product list to practically meet a best interest standard) would be permitted to provide "restricted advice" along the lines of the U.K. model. **FAIR Canada recommends that those who provide "restricted advice" must use the title "salesperson", be subject to suitability requirements, be precluded from holding out that they offer independent advice or act in the best interest of the client, and must disclose in writing and orally that they are providing restricted advice, which is not required to be in the best interest of the consumer.**

5.4. FAIR Canada recommends that anyone who purports to provide independent advice, as suggested by their business name, title or marketing and advertising materials, be required to adhere to a statutory best interest standard (as described above).

5.5. ***Conflicted Remuneration*** - **FAIR Canada recommends that those dealers and advisors who provide restricted advice, (i.e. salespersons), as with those who provide independent advice, should not be permitted to have conflicted remuneration structures in place** and should, therefore, not be permitted to receive embedded commissions, including trailing commissions. Given the problems that conflicted remuneration structures cause with respect to meeting a suitability obligation, such a reform is urgently needed.

5.6. ***Marketing and Advertising*** - Securities regulators and self-regulatory organizations would need to enforce stringent requirements with respect to marketing and advertising materials along with the use of titles and credentials to prevent consumers from being misled. As noted by the CSA, "...some advisers and dealers market their services on the explicit or implicit basis that the advice they are providing is in the client's best interests."[78] Such misleading advertising and marketing would no longer be permitted and would be strictly enforced in respect of dealers and advisors who provide restricted advice.

5.7. ***Consumer Confusion*** - If regulators opt to allow two tiers of advice –independent advice and restricted advice– then regulators must address the potential legitimate concern that there may arise some consumer confusion. Consumers may not be aware which level of service they are being provided and be confused or misled as to what standard applies. In the US, different standards currently exist for investment advisers as opposed to broker-dealers and the proposed reforms are aimed to create one standard in order to reduce confusion amongst investors and improve outcomes. As noted in the Consultation Paper, it is unclear when the SEC will move forward with the initiative.[79] Consideration will have to be given as to how to ensure that consumers are clear in the level of service they are entitled to depending on who they are dealing with.

[78] *Supra* note 60, at page 9585.
[79] *Supra* note 60, at page 9573.

RECOMMENDATION:

FAIR Canada believes that all investment advice should be subject to a best interest duty.

However, we understand that given the structure of the industry, some current business models will need to be modified significantly in order to be economically viable under a best interest standard. If regulators are not willing to impose a best interest standard on all existing business models, FAIR Canada recommends that regulators take a phased approach, and those who would need to modify their business model in order to meet a best interest duty to consumers (where they would have a wide enough product list to practically meet a best interest standard) be permitted to provide "restricted advice" similar to the model in the U.K.

FAIR Canada recommends that those who provide "restricted advice" must use the title "salesperson"; be subject to suitability requirements; be precluded from holding out that they offer independent advice or holding out that they act in the best interest of the client; and must disclose in writing and orally that they are providing restricted advice, which is not required to be advice in the best interest of the consumer.

All registrants should be precluded from using conflicted remuneration structures.

6. Exempt Market Dealers and Scholarship Plan Dealers

6.1. **FAIR Canada sees no reason to carve out exempt market dealers ("EMDs") or scholarship plan dealers from a statutory best interest requirement (nor mutual fund dealers as described in section 5.2 above). It does not appear that clients of EMDs or scholarship plan dealers are in need of less protection. In fact, purchasers of group scholarship plans are one of the most vulnerable constituencies of consumers given their lack, in many circumstances, of either English or French language skills (the mandated languages for disclosure documents in Canada), their potentially low financial literacy, the fact they are often lower- or modest-income families and given the fact that this may be the only security they will ever purchase.**

6.2. Such dealers should be obliged to recommend the product that is in the best interest of the consumer. If the product which is in the consumer's best interest is not within the scope of their registration, as indicated above at sections 5.1 to 5.2 above, they must suggest the type of product(s) that the consumer should investigate, and through which type of financial service provider it can be obtained.

6.3. If regulators opt to allow two tiers of advice, EMDs and scholarship plan dealers would be able to provide restricted advice. Accordingly, they should be required to call themselves salespersons and be prohibited from holding themselves out as providing independent advice or advice in the best interest of the client. They would be subject to existing suitability obligations and would be prohibited from receiving embedded third party commissions as described above. They would also not be permitted to hold out in their advertising or marketing that they provide advice in the best interest of the client (i.e. independent advice).

7. Ongoing Obligation or Obligation Only at Time Advice Provided

7.1. **FAIR Canada believes that the determination of whether the best interest duty would be an ongoing obligation or would only apply at the time the advice is provided will depend upon whether the relationship is an ongoing one or not.** One factor which may help determine whether the relationship is ongoing (among others, including the customer's understanding and expectations) is the fee structure. If the client pays a fee at the time of the advice or recommendation only, and the fee was intended to be paid only for that particular recommendation or transaction, then the obligation would not necessarily be ongoing. However, if the client is charged a yearly (or ongoing) fee, or the client otherwise pays for ongoing advice, then the obligation to act in the client's best interest should be ongoing. It is important that advisors and clients both clearly understand whether the obligation is intended to be ongoing. The overriding issue is whether the relationship is ongoing or not.

RECOMMENDATION:

If the consumer pays for ongoing advice, they should be provided ongoing advice and the obligation to provide advice in the client's best interest should be ongoing. On the other hand, if they request and pay for one-time advice, there is no ongoing relationship and the duty, correspondingly, should not be ongoing. The overriding issue is whether the relationship is ongoing and payment structures should not be designed to circumvent one's obligations.

7.2. ***When Consumer Does Not Follow Advice*** - FAIR Canada also agrees with the CSA's assumption that "...a retail client would retain complete discretion whether to follow any advice received; an adviser or dealer who disagrees with the investment decision of a retail client and who has so advised the client, would have no further obligation to dissuade the client or to refuse to facilitate an order...".[80] While most consumers tend to follow the recommendation of their advisor, in the situation where they do not, the financial service provider could document the circumstances and proceed to put through the transaction and the trade confirmation slip would be "unsolicited". Taking and executing unsolicited customer orders does not entail advice and therefore would not be subject to the best interest standard. Applicable suitability requirements would continue to apply.

8. Discount Brokerages

8.1. Online or discount brokers do not provide mere 'order execution services' as suggested in the CSA Consultation Paper. They provide a wide range of products and services to their clients, including extensive amounts of information and research reports with buy, hold and sell "recommendations" on individual securities including structured products. They also provide their top recommendations for individual equity and debt securities. They distribute research reports on various industry sectors, and suggest optimal asset allocations. They distribute new issues of equity and debt securities as well as structured products (where they earn full-service size commissions rather than discount broker commissions). In reality, they appear to be in the

[80] *Supra* note 60, at page 9583.

business of selling securities to their clients and are not mere order takers. The distinction between full-service brokers and so-called order execution only brokers has become blurred as both provide a comprehensive range of services.

8.2. In our view, discount or online brokers should be subject to a best interest duty if they provide advice or recommendations to consumers. We note that the current IIROC Dealer Member Rules do not permit discount brokerages to provide recommendations.[81] If restricted to order execution services, then current rules do not require them to ensure than an order is suitable to a particular customer. If they were mere order takers, it would follow that they would also not be required to ensure that an order was in the best interest of a customer (given that no advice or recommendations are being provided).

8.3. ***Review of Discount Brokerage Conflicts*** - However, given that discount brokerages appear to no longer restrict their services to mere order taking, FAIR Canada recommends that CSA members examine the services provided by discount brokerages and assess whether they should be subject to a best interest standard in respect of the services they do provide. In particular, FAIR Canada recommends that the issue of conflicts of interest between discount brokerages and their clients be considered by CSA members and addressed in the context of implementing a best interest standard. For example, with respect to order execution, discount brokerages have an obligation to their clients to provide best execution which is a form of best interest standard with respect to trading. Consequently, when trading, discount and full service brokers should not prefer a particular exchange, ATS or high frequency trader or route orders in a manner that rewards the broker for order flow while achieving less than best execution for retail clients.

8.4. In addition, in providing research to clients, the research of all firms should be professional, objective, and not influenced by inappropriate factors including a desire to be included in a distribution syndicate for a new issue and to be able to profit from the sale of that new issue to clients based in part on a less-than-objective research recommendation. As noted elsewhere in this submission, discount brokers currently accept payment of trailer commissions for mutual funds held by clients at the same level as firms that provide recommendations subject to suitability obligations even though they are not permitted to provide individual recommendations to their clients.[82] FAIR Canada questions the appropriateness of such payments in the absence of clients receiving any personalized advice in respect of such mutual funds.

8.5. **FAIR Canada wishes to make it abundantly clear that we are not critical of the expansion of discount brokerage services beyond mere order taking. In fact, the extraordinary evolution of discount brokerages since the deregulation of commission rates is a perfect example of how eliminating anti-competitive practices results in more competition and the creation of new products and services for consumers.**

[81] See Investment Industry Regulatory Organization of Canada Dealer Member Rules 3100 and 3200.
[82] See Investment Industry Regulatory Organization of Canada Dealer Member Rule 3200(3)(a).

RECOMMENDATION:

Given that discount brokerages do not restrict their services to mere order taking, FAIR Canada recommends that CSA members examine the services provided by discount brokerages and assess whether certain services that are provided to customers should be subject to a best interest standard.

Furthermore, FAIR Canada recommends that the issue of conflicts of interest between discount brokerages and their clients be considered by CSA Members and addressed in the context of implementing a best interest standard.

9. The Standard for the Sale of Other Financial Products by Securities Registrants

9.1. ***Product Convergence*** - Historically, the different pillars of the financial services sector in Canada have been regulated separately with the market conduct of insurance providers regulated provincially by insurance regulators, securities regulated provincially by securities regulators and banking regulated federally pursuant to the *Bank Act*. However, over time there has been an increasing convergence in financial products and the creation of financial conglomerates who sell a variety of financial products and services that cut across the different traditional pillars.[83]

9.2. ***Fragmented Regulation*** - Financial products have been created which are regulated differently from securities products despite the fact that they are investments and are very similar to products regulated as securities (for example, segregated funds and principal protected notes).

9.3. ***Comparable Protection*** - FAIR Canada believes that investors should receive the same level of protection irrespective of what segment or pillar of the financial service industry their financial product falls under, particularly given the fact that it is often the same financial conglomerate from whom they are buying the differently-regulated financial products, albeit a subsidiary or related entity. Such products are often sold by the same individual advisor. **From a consumer perspective, the same level of consumer protection should apply regardless of what "hat" the advisor is wearing.**

9.4. **Accordingly, FAIR Canada recommends that securities registrants be required to consider whether a financial product is in the best interest of the client, regardless of whether it is a securities-regulated financial product or not**. The same standard of conduct and duty of care (i.e. the statutory best interest standard) should apply in order to protect consumers.

9.5. An analogous approach has been taken by the CSA in respect of compliance with "know your client" and suitability obligations with respect to the sale of principal protected notes by registrants.[84] FAIR Canada sees no reason why the CSA could not issue a similar notice with respect to compliance with the statutory best interest duty for the sale of financial products such as principal protected notes and segregated funds (which are essentially mutual funds with an insurance "wrapper" and are sold by those advisors who are dually licensed to sell insurance and securities products). Compliance with the statutory best interest standard should apply to an

[83] For a discussion of the developments of the Canadian financial sector, see the Department of Finance's "The Canadian Financial Services Sector", online: <http://www.fin.gc.ca/toc/2002/fact-cfss_-eng.asp>.

[84] See CSA multilateral Staff Notice 46-306, Third Update on Principal Protected Notes.

advisor making a recommendation to invest in a segregated fund or a principal protected note or other investment product.

9.6. ***Advice to Invest in Non-Securities is Advice About Securities*** - FAIR Canada supports the position taken by the Consumer Federation of America and others to address the potential for confusion where certain advice offered by the financial service provider is subject to a best interest standard and other advice offered is not (i.e. a recommendation to buy a non-security product):

> While we agree that the standard applies to advice about securities, the application of the standard must be interpreted broadly enough to include advice not to invest in securities where securities are among the options being considered. In other words, where securities represent an alternative to non-securities, then **advice to invest in non-securities necessarily entails advice not to invest in securities, which constitutes advice *about* securities. Failure to include such advice under the standard would create an incentive to recommend non-security products simply to escape the fiduciary obligation.**[85]

9.7. **The fact that most members of the CSA do not have jurisdiction to regulate all financial products and those who provide such products to consumers (unlike some other leading jurisdictions) does not lessen the importance of the statutory best interest duty being imposed on securities registrants. Regulators have to start somewhere.**

9.8. **The above-noted steps should reduce the attempts by financial service providers to engage in "**regulatory arbitrage". Of course, regulatory arbitrage cannot be entirely prevented through one initiative given that certain providers of financial products and services are not registrants of securities commissions and, therefore, will not be held to a best interest standard.

9.9. ***Insurance Regulators*** - FAIR Canada urges insurance regulators to also adopt a best interest duty and/or require all insurance agents who sell segregated funds (or other insurance products which have an investment component) to, at a minimum, also be registered to sell mutual funds. If this was required, they would: (a) be subject to the best interest duty and (b) have a wider range of products to investigate and provide recommendations which may meet the best interest of the client standard. This would benefit consumers.[86]

9.10. ***Amend "Securities" Definition*** - **To provide consumers of segregated funds with the same level of investor protection as mutual funds, the carve-out in the provincial securities acts[87], which provides segregated funds with an exemption from securities legislation, should be removed.** Segregated funds (Insurance Variable Investment Contracts) should be rightfully determined to be a security and not exempted from provincial securities acts.

9.11. To apply a consistent level of investor protection, **FAIR Canada recommends that all securities registrants should be prohibited from *accepting* any third party embedded commissions in respect of financial products that are not regulated under provincial securities legislation that they also may be licensed or otherwise permitted to sell, in order to meet their statutory best interest duty (in order to comply with the duty of loyalty).** This will encourage the advisor to

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[85] Letter from Consumer Federation of America and others to Mary Schapiro, then Chairman of the SEC (March 28, 2012), online: < http://www.consumerfed.org/pdfs/SIFMA-FrameworkResponse3-29-12.pdf > at page 10.

[86] We have written submissions to the Financial Services Commission of Ontario ("**FSCO**") in response to their Statement of Priorities, urging them to adopt a best interest standard. See FAIR Canada's submissions to FSCO dated June 6, 2011 and June 6, 2012. Available online at http://faircanada.ca/current-issues/submissions/.

[87] For example, see the Ontario *Securities Act*, under definition of "security" at subsections (1)(1)(e)(i) and (f).

recommend the best financial product rather than the one that earns them the most commission, across the board, regardless of how the product is regulated.

RECOMMENDATION:

A statutory best interest duty should apply to a recommendation by a securities registrant to purchase a segregated fund or a principal protected note or other investment product regardless of whether it falls under the provincial securities legislation's definition of "security". The recommendation to invest in comparable products necessarily constitutes advice about securities (to not invest in a security) and should therefore be subject a best interest standard. Failure to apply the standard to a registrant selling non-securities products will create incentives to sell such products to avoid consumer protection.

10. Response to Industry Lobbyists' Arguments About Unintended Consequences if Statutory Best Interest Standard Adopted

10.1. A number of arguments have been advanced by financial industry lobbyists (particularly IIAC and IFIC) against the imposition of a best interest duty. They argue that lower-asset investors will be shut out of the market; that consumers will have less "choice" of financial products; that given increased costs lower-asset consumers will be denied access to advice and costs to consumers will increase, also leading to less access to advice. FAIR Canada's responses to their arguments are presented below.

Business Models Will Evolve Through Market Forces to Serve Client's Needs

10.2. ***The Embedded Commission Business Model*** - The IIAC submits that if a statutory best interest duty is imposed, then clients will have reduced choice amongst business models. They state that commission based accounts are popular and that a fiduciary standard will mean that commission based accounts will no longer be permitted.[88]

10.3. FAIR Canada does not see the demise of a business model that includes embedded, third-party commissions, which result in poor financial outcomes for consumers, as a negative for consumers. While it may be hugely profitable for the financial industry, FAIR Canada does not believe that it serves consumers to hide the costs and fees they pay and to provide them with conflicted advice which benefits the fund manufacturer and dealer/adviser at the expense of the consumer. To say removing this "choice" of business model will in some way harm investors is nonsensical.

10.4. The embedded commission based accounts are the most popular form of account at present likely because (1) investors are unaware of what they are being charged; (2) many think they are getting "advice" for free; and (3) they are sold that type of account in order to obtain them as a client (without the investor understanding the amount they pay for the services they obtain nor how the fees are reducing their return by significant amounts over time).

[88] *Supra* note 72.

10.5. ***Consequences of Conflicted Remuneration*** - The conflicted remuneration structures in the present commission-based model results in:

- product recommendations which pay the advisor a higher commission rather than the best product for the client;
- recommendations to leverage without a balanced presentation of the risks versus the benefits of such a strategy;
- portfolios too heavily invested in equities (given that equity funds pay higher trailing commissions); and
- churning of accounts or switching from DSC to front-end loads after the expiry of the trailer to reactivate the trailing commission payment.

Advice under the current embedded commission model often results in poor (and in the case of leverage, potentially disastrous) results for investors but profits (regardless of financial outcomes for the client) for the firms and their sales force.

10.6. ***Deregulation of Commissions*** - The deregulation of commission rates is an example of a key change in securities legislation which some industry participants opposed, but which led to important changes to the financial markets, with positive opportunities for individual retail investors. In 1975, the United States enacted a number of securities act amendments including abolishing fixed trade commissions. Canada (and other jurisdictions) followed suit and deregulated commission rates in 1983. Deregulated commission rates changed the organizational structure of securities firms and stock exchanges.[89] While many brokerages left the rates alone or raised the commissions for smaller individual clients while reducing rates for large institutional clients, other market participants saw an opportunity to pursue a new kind of brokerage model that provided lower cost transactional services, and the financial industry saw the development of the "discount brokerage".[90]

10.7. FAIR Canada provides this as an example of how securities market participants can adapt to the elimination of anti-competitive rules and create new business models which serve segments of the consumer investment market.

10.8. In any event, the IIAC is wrong to suggest that the commission-based business model will be unavailable. In FAIR Canada's view, a best interest standard will not remove the ability to charge upfront commissions for the sale of financial products if such charges are paid directly by the consumer to the firm/advisor as a commission rather than being deducted from the total amount paid by the investor (with the remaining amount being invested in the investment) so as to be clear and transparent. However, deferred sales charges and other forms of embedded third party commissions must be prohibited given the perverse effects they have on recommendations and given that they are opaque costs that many investors do not know exist nor understand well, even if they do know they exist, and which create misaligned incentives.[91]

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[89] Roberta S. Karmel, "A Retrospective on the Unfixing of Rates and Related Deregulation", online: <http://www.world-exchanges.org/insight/views/retrospective-unfixing-rates-and-related-deregulation>.

[90] Charles Schwab, "May 1st Marks 30th Anniversary of Brokerage Commission Deregulation" (April 28, 2005) (news release) online: <http://www.prnewswire.com/news-releases/may-1st-marks-30th-anniversary-of-brokerage-commission-deregulation-54435272.html>.

[91] *Supra* note 19. Only one-third of investors were aware of trailing commissions, and that investors have little or no idea about how advisors can get paid and most cannot rationally assess the conflicts of interest in light of knowledge about how advisors are paid and most believe that the advisor will look out for their best interest regardless of how they are paid.

10.9. ***Other Business Models*** - It is our understanding that the fee-based compensation system which charges fees based on the amount of client's assets under management, as presently structured, generally imposes higher percentage fees for those with lower levels of assets, and is not always available to those who have less than a minimum asset threshold. It is also argued by some that this type of account is not suited to the buy and hold investor. While this may be true, FAIR Canada is confident that the market will adjust to the best interest regulatory standard and that new business models, including different fee-based compensation systems or other alternative business models, will emerge to take advantage of the various segments of the market, including the lower asset segment.

10.10. FAIR Canada believes that if effective competition is promoted through the implementation of a best interest duty more consumers will choose a lower-fee model. Further, new choices will emerge for investors and that advice will be available, likely at a lower cost than is presently unwittingly paid. Innovation and competition will drive down consumer costs. This will improve financial outcomes for consumers.

10.11. In addition, other business models do exist at present which may gain popularity in the new regulatory environment[92]. Fee for service advice is presently available. For investors who want to pay an hourly fee or fixed fee, there are firms and financial service providers that will provide unbiased advice. Such services are not always associated with product recommendations but can be.

10.12. The use of discount brokerages may increase in popularity. For those who are willing to try "do it yourself" investing, using a discount broker is an alternative. Discount brokerages offer a number of useful general research and general investment and allocation strategy literature and calculators, even though they are not permitted to provide personal recommendations.

10.13. FAIR Canada believes that there will continue to be choices of different business models. Many firms could continue to offer commission-based accounts (but not embedded commissions) or fee-based accounts, and provide advice as to what account type the customer should enter into based on the best interest of the consumer.

Costs (Compliance, Legal, Commercial) Will Not Be Significantly Higher Under a Best Interest Standard

10.14. The IIAC also argues that compliance costs will increase in order to meet a fiduciary duty which will result in increased costs for clients of financial advice. They appear to rely heavily on the study commissioned by the Securities Industry and Financial Markets Association (the securities industry lobby group in the United States), conducted by Oliver Wyman (the "**SIFMA Study**") and published October 2010. The study collected data from a broad selection of retail brokerage firms to assess the impact of changes to the existing standard of care for broker-dealers and investment advisors. Seventeen firms provided data that, according to the study, thereby captured approximately 33% of households and 25% of retail financial assets in the U.S.

[92] See the following possibilities which exist in other jurisdictions: For example, the use of technology through software services such as MoneyVista, Betterment (https://www.betterment.com/about/) and Flat Fee Portfolios. In Canada, BMO Investorline introduced adviceDirect – the first service of its kind in Canada to offer investing advice to online investors. The approach received a special exemption from regulators which suggests that advice delivery innovations will be considered by regulators in the future (see http://www.osc.gov.on.ca/en/SecuritiesLaw_sn_20121122_33-738_annual-rpt-dealers.htm) which works on a fee-based model.

10.15. FAIR Canada disagrees that compliance costs will significantly increase or that the costs of providing "advice" will increase. Firstly, if many elements of the requisite standard of care under the statutory best interest standard are already in place (as is argued by industry) and, if they are being followed, any additional steps which may need to be taken to meet the statutory best interest standard should be relatively minor to implement – suggesting no significant additional cost is required. FAIR Canada believes that some firms may currently be meeting a best interest standard; for these advisers and dealers the implementation of such a duty will have minimal impact on their costs.

10.16. Secondly, we do not believe that a study funded by an industry lobby group is as convincing as an independent study. An independent study published in March 2012 entitled "The Impact of the Broker-Dealer Fiduciary standard on Financial Advice" conducted by Michael Finke and Thomas Patrick Langdon (the "**Academic Study**") compared states in the U.S. that apply a strict fiduciary standard to those states that apply no fiduciary standard. **The study found "...no statistical differences between the two groups in the percentage of lower-income and high-wealth clients, the ability to provide a broad range of products including those that provide commission compensation, the ability to provide tailored advice, and the cost of compliance."**[93]

10.17. As stated in the Consultation Paper, "...the Academic Study concludes that "[e]mpirical results provide no evidence that the broker-dealer industry is affected significantly by the imposition of a stricter legal fiduciary standard on the conduct of registered representatives." In part, that is because broker-dealers are already subject to suitability requirements that have the effect of imposing significant costs on the industry." [94] This should hold true in respect of Canada as well.

10.18. Thirdly, the SEC staff study on the obligations of brokers, dealers and investment advisers noted the possibility that the change in standards might result in reduced administrative and compliance costs.[95] Compliance costs with the new best interest standard should not be significantly different.

10.19. As noted above at section 2.27 under Agency Costs, consumers incur agency costs as a result of the existing suitability standard. Imposing a statutory best interest standard will result in a benefit to consumers by reducing the agency costs of monitoring the financial service provider who has superior information.[96]

10.20. ***Legal Costs Should Not Be Significantly Different*** - FAIR Canada believes that imposing a statutory best interest standard will result in clarity for financial service providers and their clients and end confusion about when the standard applies. Rather than having to litigate to determine whether the particular facts and circumstances of the relationship in question have all of the requisite indicia of a fiduciary relationship[97], consumers and their financial service provider will know that a "best interest" standard applies if advice is given or a recommendation is provided. **Reducing legal uncertainty should reduce legal costs. Moreover, reducing uncertainties about the legal obligations of dealers and advisers should result in better**

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[93] *Supra* note 60 at page 9573-9574 and Michael Finke and Thomas Langdon , *The Impact of the Broker-Dealer Fiduciary Standard on Financial Advice* (March 9, 2012) online: <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2019090> at page 1.

[94] *Supra* note 60 at page 9574.

[95] Staff of the U.S. Securities and Exchange Commission, 2011 as referenced in *supra* note 93 (Finke and Langdon) at pages 16-17.

[96] See *supra* note 93 (Finke and Langdon) at page 23.

[97] *Supra* note 60 at page 9561.

outcomes for consumers and less likelihood of litigation, and thereby reduce legal costs for dealers and advisers.

10.21. The IIAC's submission suggests that given increased liability and risk, advisors may limit the type of products they can provide or constrain their advice. FAIR Canada does not see this as a negative consequence of imposing a best interest standard if poor products are removed from sale and advisors are more careful in the advice they provide to consumers. This should reduce liability further from that which exists today, thereby reducing legal costs for dealers and advisers. As noted above, the standard of care will not be greater for lower net worth clients, so these clients will not be more expensive, from a legal costs perspective, to serve.

10.22. ***Legal Action Not Feasible for Majority of Canadians*** - Currently, the vast majority of consumers are not able to pursue legal action in respect of unsuitable recommendations and the harm that it causes them given the prohibitive legal costs they have to incur. The legal costs to pursue a civil action against an advisor and/or his or her dealer or financial institution are too great unless the loss has been significant[98] and the chances of success are high (as the losing party to an action is normally required to pay party and party costs to the other side). Moreover, law suits are often settled before trial for less than the financial loss suffered by the consumer and often from this amount the consumer must pay their own legal fees.

10.23. ***Remedies Will Not Result in Unfairness*** - Some providers of legal services to the financial industry argue that imposing a fiduciary standard will result in depriving the financial service provider of certain defences such as the consumer being partly responsible for a loss or that losses are attributable to market events rather than negligence.[99]

10.24. Firstly, this argument is not correct given that the common law fiduciary duty is not being implemented but rather a statutory best interest standard.

10.25. Secondly, the current state of the law on fiduciary duty does not support the argument made. While "[t]raditionally, the fiduciary concept and other equitable doctrines were unconcerned with notions of foreseeability, remoteness, and other considerations that may have long affected the quantum of relief under the common law"[100], more recent jurisprudence in Canada and elsewhere has demonstrated that the courts have tended to merge the principles of law and equity such that equitable remedies can also include concepts such as remoteness, responsibility for one's own losses and mitigation.[101] As stated by La Forest J. in *Canson*: "barring different policy considerations underlying one action or another, I see no reason why the same basic claim, whether framed in terms of a common law action or an equitable remedy, should give rise to different levels of redress."[102]

10.26. There is also precedent which suggest that fiduciaries are not guarantors and will not be held responsible for market forces beyond the fiduciaries' control unless in the circumstances it is appropriate to do so.[103]

[98] Our understanding is that claims for losses less than $200,000 are not worth pursuing in a civil action given legal costs.
[99] David Di Paolo, Kara Beitel, "No Fiduciary Standard Needed in Canada" (May 12, 2011) in Advisor.ca.
[100] Dr. Leonard I. Rotman, *Fiduciary Law* (Toronto: Thomson Carswell, 2005) at 634 [Rotman].
[101] See *Canson Enterprises Ltd. v. Boughton & Co.* [1991] 3 SCR 534. See also Rotman at page 651.
[102] *Ibid*.
[103] *Supra* note 101 and Rotman at page 672.

10.27. In any event, FAIR Canada suggests that the issue of the appropriate type of remedies for breach of the statutory best interest standard can be stipulated; however, this should be done on a principled basis and in a manner that results in an equitable and fair result.

New Financial Products that Meet Consumers' Needs

10.28. There is no evidence that financial products will not be economically viable should embedded commissions be removed and there is full transparency and a best interest duty. If certain financial products do become economically unviable upon implementation of a statutory best interest duty, this demonstrates that they have little economic value to consumers and that consumers will benefit from the introduction of the statutory standard.

10.29. FAIR Canada has ample faith in the financial industry's ability to adapt to greater competition, by making financial products that do meet the best interest standard, thereby likely improving financial outcomes for consumers.

10.30. ***Principal Trades*** - Members of the CSA, when making recommendations regarding a specific statutory best interest duty, should examine the approach to principal trading restrictions, especially with regard to the fixed income market. Members of the CSA, together with IIROC, should examine whether the over-the-counter securities fair pricing rule is sufficient to ensure that fixed income trades are in the best interest of the consumer.[104] While IIROC's over-the-counter securities fair pricing rule[105] took important steps to improve disclosure and ensure trades are fair to consumers, the rule should be assessed against the best interest standard. There is currently a lack of transparency in regards to commissions for the sale of fixed income products. This needs to be remedied. The goal should be to provide a framework for principal trades that allows trades to go forward where they are demonstrably in the best interest of the consumer.[106]

10.31. ***Proprietary Products*** - While the IIAC suggests that proprietary products "may not be available to clients"[107], FAIR Canada suggests that such products should be assessed against the statutory best interest standard and whether the recommendation from a limited product list (for example) meets the best interest standard (or not). It does not follow that they will no longer be available if such a standard is imposed but there will be a new standard against which to measure them.

10.32. ***The Experience in the U.K. Post-Retail Distribution Review*** - Industry lobby groups are likely to argue that the so called "advice gap" that has been created in the United Kingdom as a result of the Retail Distribution Review, (where certain consumers of lower or modest income would be unable or unwilling to obtain advice) demonstrates that similar changes should not be made in Canada. FAIR Canada wishes to point out that the "advice gap" is something that is projected to occur by some observers, not something that in fact has already happened. Moreover, FAIR Canada sees U.K. consumers' survey responses as rational reactions to new knowledge about

[104] See IIROC Notice #11-0256, Over-the-counter securities fair pricing rule and confirmation disclosure requirements, including Dealer Member Rule 3300and rule 200.1(h).
[105] IIROC's over-the-counter securities fair pricing rule, IIROC Notice 11-0256; Dealer Member Rule 3300 and Dealer Member Rule 200.1(h).
[106] This is the position taken by the Consumer Federation of America and others, *supra* note 86 at page 6.
[107] *Supra* note 72 at page 4.

the cost (and the fact of the cost) of advice. The U.K. market will adapt to meet those consumers needs.

10.33. The regulatory changes in the U.K. only came into effect on January 1, 2013. Deloitte LLP commissioned a survey of more than 2,000 UK adults to understand how consumers expect to react to the new rules (the "**Deloitte Report**").[108] The Deloitte Report asked consumers if they would reduce the use of advisors if charged a fee of 3% of their investment, and the results indicate that consumers expect to behave differently as a result of becoming more aware of adviser costs and that independent financial advisers (IFAs) and bank advisers will also change their business model and de-prioritize a large segment of their customers as they move towards higher net worth consumers in order to defend their existing profit margins, given their assumption that consumers with lower levels of savings will be less willing or able to pay for advice.

10.34. **The Deloitte Report notes that "[c]ustomers are likely to stop using financial advisers, switch to cheaper sources of advice/intermediation or accept the costs but seek better quality service."[109]** It notes that the wealth of a customer is the primary factor in determining willingness to pay adviser charges: "This reflects the fact that the opportunities arising from good advice, and the costs from bad advice or not taking any advice, can rise in line with the size of a customer's investment. For example, there are significant tax planning opportunities which advice can reveal for affluent customers that do not exist for those who have smaller tax liabilities."[110] It also notes that certain distribution channels will be more affected than others given the types of customers they serve and the perceived value that they add.[111]

10.35. **FAIR Canada sees the customer survey responses to be a rational response to the learned information about the costs of advice. Switching to cheaper sources of advice, doing it oneself, or demanding greater value from the advisor are rational responses to the "new" information learned.**

10.36. The Deloitte Report estimates or projects that 11 percent of U.K. adults will either choose to cease using financial advisers or lack access to them. The Deloitte Report indicates that these consumers are a "major opportunity for product providers"[112] and advisers and it identifies four major target customers segments which each "...represents an opportunity for the provider who can serve it with the right blend of route-to-market (e.g. direct-to-customer, adviser or other partnership), delivery format and pricing"[113].

10.37. **The Deloitte Report notes that the regulatory changes associated with RDR will change the retail distribution landscape in the U.K. and will lead to market opportunities for advisers and providers to target new market segments with appropriate products and services through the appropriate channels.** While the industry will try to use the U.K. example of the "advice gap" projected as a result of the RDR as a reason not to implement most needed changes, **the Deloitte Report supports FAIR Canada's view that the market will adapt to serve consumers needs**.

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[108] Andrew Power, Seb Cohen and Peter Evans, *Bridging the advice gap: Delivering investment products in a post-RDR world* (November 2012), online: <http://www.deloitte.com/assets/Dcom-UnitedKingdom/Local%20Assets/Documents/Industries/Financial%20Services/uk-fs-bridging-the-advice-gap.pdf>.

[109] *Ibid.* at page 5.

[110] *Ibid*.

[111] *Supra* note 108 at page 8.

[112] *Supra* note 108 at page 11.

[113] *Supra* note 108 at Forward.

Cost-Benefit Analysis

10.38. FAIR Canada has throughout this submission articulated the benefits of implementing a best interest duty and has refuted industry's arguments that the cost of introducing such a duty is too high. In our view, a quantitative cost-benefit analysis risks being (1) highly inaccurate and (2) not the correct yardstick with which to measure the concept of a statutory best interest duty. It is exceptionally difficult to quantify the value of consumer protection, and we do not believe that this is the appropriate approach to justifying the imposition of a best interest duty.

10.39. ***More Study A Delaying Tactic*** – Industry lobby organizations opposed to regulatory reform invariably propose that regulators undertake more studies (including cost benefit analysis) as a tactic to derail and delay investor protection reforms. This tactic is currently being used in the U.S. to prevent the introduction of a uniform fiduciary duty standard by the SEC. Industry stakeholders do not call for similar studies when reforms they support (such as "crowdfunding") are proposed. Regulators should see through these delaying tactics.

10.40. FAIR Canada strongly believes that it is desirable and feasible to implement a best interest duty that ensures that consumers are protected and that they are able to have access to the financial services that they need to achieve their retirement or other investment goals. We urge the CSA to not delay and to move forward to implement such a duty as soon as possible.

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Ermanno Pascutto at 416-214-3443 (ermanno.pascutto@faircanada.ca) or Marian Passmore at 416-214-3441 (marian.passmore@faircanada.ca).

Sincerely,

Canadian Foundation for Advancement of Investor Rights

cc: British Columbia Securities Commission
Alberta Securities Commission
Saskatchewan Financial Services Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
Nova Scotia Securities Commission
New Brunswick Securities Commission
Prince Edward Island Securities Office

Office of the Superintendent of Securities, Government of Newfoundland and Labrador
Department of Community Services, Government of Yukon
Office of the Superintendent of Securities, Government of the Northwest Territories
Legal Registries Division, Department of Justice, Government of Nunavut

APPENDIX A - DEFINITIONS

In this paper:

- **Advisor** – FAIR Canada uses this term as we understand it to be used colloquially, that is, as industry participants and members of the public use this term to refer to any individual or other service provider who provides advice (whether it be advice to purchase a specific product, financial planning, or makes any other recommendation with respect to investments). The term "advisor" is not indicative of an individuals' category of registration with Canadian securities regulators. The requirement to comply with a best interest standard would rest at the firm level, so use of the term "advisor" throughout may also incorporate reference to advisers and dealers.
- **Financial Service Provider** – any person or firm who provides financial services to retail investors, including, but not limited to, those who provide advice free of conflict, salespeople, and financial planning service providers.
- **Conflicted Remuneration** – any form of remuneration (including commissions, "grid"-based compensation, bonuses, gifts-in-kind, or other benefit, etc.) that could be expected to influence an advisor to choose a particular product over other products for the advisor's own benefit or that otherwise colour the financial product advice given to clients, including other false incentives, internal or external to the firm.
- **Independent Advice** – advice provided by an advisor, in the best interest of the consumer.
- **Restricted Advice** – advice provided by a salesperson, subject to a suitability standard.