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

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Re: Request for Public Comments – Client Relationship Model

We are pleased to provide you with the comments of the Canadian Foundation for the Advancement of Investor Rights ("FAIR Canada") in response to the above request for comments on the Client Relationship Model (09-0120, issued April 24, 2009).

FAIR Canada is a non-profit, independent national organization dedicated to representing the interests of Canadian investors. The mission of FAIR Canada is to be a voice for investors in securities regulation and a catalyst for enhancement of the rights of Canadian shareholders and retail investors. Visit www.faircanada.ca for more information.

OVERVIEW

The financial crisis has accelerated the trend throughout the developed world to re-examine the relationship between investors and their advisors.

- As usual the U.K.'s Financial Services Authority is leading the way. In a dramatic step to better align the interests of investors and advisors, the FSA has proposed banning sales commissions for financial representatives and moving to a fee-based model for advisor compensation.
- In the U.S., the Obama administration has proposed creating a Financial Consumer Protection Agency and imposing uniform fiduciary duty obligations on all financial salespeople, requiring

them to put their clients' interests first. New SEC Chair Mary Shapiro has given speeches acknowledging that the SEC has lost its way and calling for a return to its roots as "the investor's advocate."

- The European Union, Australia and other countries have implemented or are in the midst of major and far-reaching initiatives.

Canada had been a pioneer examining a complete overhaul of the client/advisor relationship. Serious discussion of these issues produced the Ontario Securities Commission's Fair Dealing Model (FDM) proposals in 2004. The FDM sought a far-reaching overhaul of all the rules affecting retail financial services based on simplicity and maximising investor access to investment instruments regardless of the distribution channel. To further transparency the FDM 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.

Sadly, the Fair Dealing Model was never implemented. The FDM has since been carved up into different areas of responsibility. Self-regulatory organizations for the investment dealers (IIROC) and the mutual funds (MFDA) have proposed rules about relationship disclosure, conflicts of interest, suitability of investments, client reporting and communications, and performance reporting. The Canadian Securities Administrators (CSA) are addressing registration reform and the complaints handling process.

Recommendation: FAIR Canada is generally supportive of the IIROC and MFDA proposals. These steps represent incremental improvements in the Client Relationship Model. However, they do not move far enough towards the necessary complete overhaul of the relationship between the client and the advisor. We call on the CSA, IIROC and the MFDA to undertake a review of regulatory initiatives around the globe to ensure that Canadian investor protection keeps up with international best practices.

A) Relationship Disclosure

Too many retail investors are confused and overwhelmed with the paperwork they receive when they first open an account with their financial services firm. Most have no idea how much they are paying for financial advice, what services their advisor offers, or other significant information.

The goal of relationship disclosure is laudable: to present all customers with a clear, easily comparable document in plain English, aggregating all of the customer's information, the services offered, the fees to be charged, and other information that would be considered material by a reasonable investor.

The proposed IIROC relationship disclosure rules are an important step in disclosing information that an informed client needs to know. The long list, in addition to the basics described above, includes descriptions of the type of relationship with the advisor (whether managed, advisory or execution-only); the method and frequency of review of client suitability processes; a statement about how dealers disclose and address conflicts of interest; a description of the type and frequency of account and performance reporting; and an explanation of the complaint handling procedures.

IIROC's initial proposal called for all of this information to be aggregated in one document. In the face of industry concerns about the high costs of new systems and of duplication of existing information, the proposal was amended to allow dealers to incorporate such documents by reference. IIROC's current proposal allows other documents to be incorporated by reference, diminishing the benefit of simplified relationship disclosure. In a world where too few investors actually read or review opening documents because of their length and complexity, we should be doing everything possible to make this information easily accessible to investors.

Recommendation: FAIR Canada calls for a single opening document collecting all of the information important to an investor. At the very least, the main disclosure document should include a summary in plain language of any documents incorporated by reference.

B) Conflicts Management/Disclosure

IIROC proposes toughening up existing rules about conflicts of interest between investors and their advisors. Where conflicts cannot be avoided, they must be disclosed and addressed in the best interests of a client.

The detailed guidance talks ab**o**ut addressing "Conflicts of Interest in a fair, equitable and transparent manner, and by exercising responsible judgment influenced only by the best interest of the client." The new rules require IIROC dealer members to have written procedures and policies for identifying, avoiding, disclosing and addressing conflicts between the client and the dealer member.

The guidance goes on to reassure brokers that there is no conflict in the normal course of business – of course, the grounds of perhaps the most significant conflict of all. "The fact that that Dealer Member and its representatives earn commissions from recommended trades is a conflict that arises in the regular course of business" can be addressed through disclosure of fees and commissions, according to the proposal. The document goes on to say that some conflict situations may need informed consent (e.g. a written agreement before entering into a referral agreement) or even require the client to receive independent financial advice.

Other countries are addressing these larger conflicts head on. The U.K.'s Financial Services Authority has proposed banning commissions. In the U.S., the Obama administration is proposing a uniform federal fiduciary duty that would apply to all financial service providers.

Recommendation: FAIR Canada supports the proposed new conflict management and disclosure rules. Much more is needed, particularly regarding the question of fiduciary responsibility and the conflict of interest between the client, the advisor and the firm. We call on the regulatory authorities to study international best practices regarding advisor compensation and fiduciary obligations to ensure that Canadian investors have the same protection as investors in the U.S., the U.K. and other leading financial markets.

C) Suitability

IIROC proposes expanding the frequency and depth of existing requirements to assess the suitability of trades accepted and recommendations made on retail accounts.

- Events such as major transfers/deposits into accounts, material changes in client circumstances, or a change in the account representative) should "trigger" a full-scale suitability review.
- Suitability reviews should now take into account other investments in the client's account as well as past measures such as the client's financial situation, investment knowledge and objectives, and risk tolerance.
- Dealers should conduct such reviews at least annually, and consider conducting reviews after major market moves.

IIROC is contemplating further changes to the suitability rules and supervisory requirements. We understand that a major review of "know your client" practices and the definition of sophisticated investors is forthcoming.

A frequent source of investor complaints, particularly after market crashes, is inappropriate asset mixes. Both dealers and investors have a duty to monitor these matters closely and ensure that actual portfolios do not deviate from the client's stated asset mix and risk tolerance objectives.

Recommendation: FAIR Canada endorses these new rules as important steps to monitor clients' accounts. We look for tight supervision and enforcement of these suitability rules, with significant deterrent punishments in the case of violations, to ensure that firms and advisors have compelling incentives to comply with the rules.

D) Account performance reporting

A very basic right of investors is to know clearly how their investments are performing. Most want the simplest number available – what has been my total return over the past year? How does it compare to the most relevant benchmark?

FAIR Canada supports the IIROC statement – "we believe that account percentage return information is important for clients, as it allows for easy comparison of actual account returns to potential returns that might be received from other investments." Unfortunately, IIROC then proceeds to backtrack by not mandating detailed performance and benchmark calculations at this time.

Several financial service companies have complained about the difficulties of providing such calculations. It is true that sometimes it is hard to get historical cost information. And there are occasionally illiquid assets that are hard to value.

But for the vast majority of retail accounts these calculations are not that difficult. There is an entire industry devoted to performance measurement in the institutional world. Numerous systems are available to slice and dice investment performance by category, style, and a host of other factors. It is hard to accept that providing such a service is too big an obstacle for investment dealers.

We suspect that a certain element in the financial services industry does not particularly want its customers to have clear, easily comparable information that truly helps them understand how their investments have performed.

IIROC's proposal to require dealers to provide annual cumulative returns going forward is too weak a compromise. Firms are not to be compelled to provide periodic calculations of annual returns. Member

firms are permitted (but not required) to provide reports of annual returns, based on the IIROC allowable calculations. They are also permitted (but not required) to include a benchmark.

Note that the new regulations in the U.K. require both the calculation of annual returns and the inclusion of the benchmark returns.

Recommendation: FAIR Canada calls on IIROC and the CSA to require calculating and reporting client portfolio returns at least annually, if not more frequently. The regulators should also mandate the inclusion of the returns of the relevant benchmarks.

CONCLUSION

The new CSA rules and the IROC/MFDA proposals are incremental improvements in the longer process towards addressing conflicts of interest, lack of information and other problems in the client/advisor relationships. But they do not move far enough towards the necessary complete overhaul of the relationship between the client and the advisor. While some issues (registration and customer complaints) are being addressed, others are not even on the radar screen. There has been very little public discussion in Canada about the international initiatives to reduce or eliminate broker/advisor conflicts.

Canadians investors deserve a further-reaching shift in how financial services are sold and delivered in this country. FAIR Canada calls on the Canadian Securities Administrators, IIROC and the MFDA to undertake a review of regulatory initiatives in the world's leading financial markets. Imposing a uniform fiduciary duty on all advisors would be consistent with investor expectations and with how advisors and financial firms market their services – and would better align the interests of all parties.

We would be pleased to discuss our comments with you in more detail at any time.

Sincerely,

Canadian Foundation for Advancement of Investor Rights We call

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