



Canadian Foundation *for*
Advancement *of* Investor Rights

November 12, 2012

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Sent via e-mail to: rkeller@iirc.ca

RE: Request for comments on draft guidance regarding compensation structures for retail investment accounts

FAIR Canada is pleased to offer comments on the Request for Comments by the Investment Industry Regulatory Organization of Canada (“**IIROC**”) regarding the draft guidance regarding compensation structures for retail investment accounts (the “**Draft Guidance**”) contained in the notice and request for comments dated August 14, 2012 (the “**Notice**”).

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.

FAIR Canada Comments and Recommendations – Executive Summary:

1. FAIR Canada is supportive of IIROC’s objective of issuing guidance to identify specific considerations that should be taken into account in designing, recommending and supervising compensation arrangements.
2. FAIR Canada supports the emphasis that is placed on the appropriateness of a given account’s compensation structure. It is essential that the ultimate responsibility for this lies with Dealer Members to ensure that appropriate compliance systems are in place and to encourage a firm culture that prioritizes appropriateness for individual investors over the Dealer Members’ and representatives’ remuneration.
3. With respect to disclosure, and given the informational asymmetry that exists between financial consumers and financial service providers, so-called “informed preference” of the client should never absolve financial service providers of their obligation to recommend the most appropriate compensation structure for a given account.

4. FAIR Canada is concerned that too much reliance is being placed on disclosure of conflicts of interest in adhering to Client Relationship Model (“**CRM**”) requirements by industry participants as opposed to avoidance and control of conflicts of interest.
5. FAIR Canada recommends that IIROC include in its guidance that one of the specific factors Dealer Members should take into account when assessing the relative suitability of commission-based versus fee-based accounts on behalf of a given retail client be “the type and scope of advisory service the client has requested and the Dealer Member has agreed to provide”.
6. FAIR Canada supports IIROC’s general principle that a client only be moved from a commission-based account to a fee-based account (or vice-versa) when such a change is demonstrably beneficial to the client.
7. FAIR Canada continues to be concerned about trailing commissions being paid to discount brokerages which are precluded from providing advice to investors.
8. Outside the ambit of this consultation, FAIR Canada suggests that the CSA should not outright dismiss the policy option of banning third-party commissions so as to reduce the number of conflicts of interest in the consumer-sales representative/dealer relationship and reduce the misalignment of incentives.
9. FAIR Canada supports the guidance regarding the avoidance of double charging for embedded-fee securities.

1. General Comments

- 1.1. FAIR Canada supports IIROC’s objective of issuing guidance to identify specific considerations that should be taken into account in designing, recommending and supervising compensation arrangements.
- 1.2. We also support IIROC’s clarification that the guidance applies to all compensation structures and the provision of specific considerations and recommendations regarding the choice between commission- and fee-based accounts.

Suitability

- 1.3. FAIR Canada supports the emphasis that “one of the key factors that Dealer Members should consider is the account’s compensation structure”¹. This is a key element of the CRM and of IIROC Rule 1300.1, and we note the importance of ensuring that the account type is subject to a suitability assessment at the time of account opening. Further, we support the expectation that policies and procedures must be in place to ensure that the account compensation structure remains suitable for the client on an ongoing basis (i.e. “going forward”, as noted in the Notice).

¹ IIROC Notice 12-0253 - draft Rules Notice at page 6.

It is essential that the ultimate responsibility for this lies with Dealer Members, to ensure that appropriate compliance systems are in place, and to encourage a firm culture that prioritizes appropriateness for individual investors over the Dealer Members' and representatives' remuneration.

Disclosure

- 1.4. We question what is meant by the "informed preference of each client" with respect to compensation structure. It is FAIR Canada's view that, given the informational asymmetry between retail investors and financial service providers, retail investors should be recommended the compensation structure that is most appropriate given their particular circumstances, as outlined in the IIROC Guidance Note² issued concurrently with the CRM announcement. "Informed preference" of the consumer, who will typically look to the representative for advice, should never absolve financial service providers of their obligation to recommend the most appropriate compensation structure for a given account.
- 1.5. Furthermore, FAIR Canada views the approach to dealing with conflicts of interest to be one of the most fundamental elements of both CRM and any compensation structure guidance. We are concerned that too much reliance is being placed on disclosure of conflicts of interest by industry participants. FAIR Canada is alarmed about the weight being put on disclosure, particularly in light of much evidence (both within and outside the financial services context) about the ineffectiveness and unintended effects of disclosure of conflicts of interest. In our view, disclosure is not the ideal way to manage conflicts, particularly given the nature of advisor-client relationships and the demonstrated client expectation gap between suitability and best interests. Typically, the approach to management of conflicts of interest, in preferred order is (1) avoid; (2) control; and (3) disclose. In our opinion, disclosure alone will generally not be adequate to manage conflicts of interest.

Specific Issues to Consider

- 1.6. FAIR Canada recommends that IIROC include in its guidance that one of the specific factors Dealer Members should take into account when assessing the relative suitability of commission-based versus fee-based accounts on behalf of a given retail client be "the type and scope of advisory service the client has requested and the Dealer Member has agreed to provide". This goes beyond the client's anticipated requests for advice or other services to include the nature of the services that are intended to, and will, be provided. While fee-based accounts reduce conflicts, as discussed in Kenmar Associates' submission they provide "plenty of room to take advantage of the investor".
- 1.7. FAIR Canada supports IIROC's general principle that a client only be moved from a commission-based account to a fee-based account (or vice-versa) when such a change is demonstrably beneficial to the client.

² IIROC Notice 12-0108, dated March 26, 2012.

Trailing Commissions

- 1.8. We are concerned that one of the advantages identified in a commission-based account is that the “client incurs no cost”³ when the client’s account is inactive – either because no recommendation has been made or because the advisor has recommended a long-term hold on a security. This does not appear to contemplate trailing commissions, which are paid indirectly out of investors’ funds irrespective of the level of service they receive.
- 1.9. Furthermore, FAIR Canada continues to be concerned (both from a legal and fairness perspective) about the same amount of trailing commissions being paid to discount brokerages (this issue is also raised in Kenmar Associates’ submission in response to the Notice) which are precluded (in accordance with securities regulations) from providing advice to investors as are paid to Member firms and representatives that are able to provide advice to investors.

Third-party Commissions

- 1.10. Outside the ambit of this consultation, FAIR Canada suggests that the CSA should not outright dismiss the policy option of banning third-party commissions. As Noted in the Draft Guidance, “the FSA determined that third-party commissions introduced an *unacceptable bias* into the sales process.”⁴ While we recognize that such a ban would provoke strong push back from industry, we note that this is the approach that has been taken by other leading jurisdictions and should not be ruled out as one option for dealing with conflicts of interest inherent in such commission structures. In FAIR Canada’s opinion, this option should be open for discussion.

Double Charging

- 1.11. FAIR Canada supports the guidance regarding the avoidance of double charging for embedded-fee securities. It is essential that Dealer Members have practices in place to ensure that clients are not double charged.

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).

Sincerely,



Canadian Foundation for Advancement of Investor Rights

³ *Supra* note 1 at page 6.

⁴ Emphasis added.