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

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RE: IIROC Request for Comments re Client Relationship Model – Phase 2, Performance Reporting and Fee/Charge Disclosure

FAIR Canada is pleased to offer comments on the Investment Industry Regulatory Organization of Canada's ("**IIROC**") Request for Comments regarding IIROC's proposed amendments to Dealer Member Rules 29, 200 and 3500 and to Dealer Member Form 1 (collectively the "**IIROC CRM2 Amendments**") to implement IIROC rule requirements that are substantially the same as the amendments to National Instrument 31-103 announced by the Canadian Securities Administrators ("**CSA**") on March 28, 2013 relating to annual account performance reporting, pre-trade and trade confirmation disclosures and annual account fee/charge reporting (collectively, the "**CSA CRM2 Amendments**") (together, the "**CRM2 Proposals**").

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.

1. FAIR Canada Supports Cost Disclosure and Performance Reporting

1.1. FAIR Canada supports the proposed cost disclosure and performance requirements contained in the CRM2 Proposals and the commitment that regulators have made to the provision of this crucial financial information to financial consumers. The self-regulatory organizations, namely IIROC in this instance, are adopting rule requirements that are substantively and substantially the same as the CSA CRM2 Amendments so that IIROC's dealer members will be subject to a single set of client reporting and disclosure requirements, in an effort to reduce the compliance burden. FAIR Canada is supportive of this so long as all firms, regardless of whether they are a member of IIROC or the MFDA or are directly supervised by a CSA member, are subject to the same requirements without any material differences. It is important that consumers can meaningfully compare the

reports they may receive from various firms irrespective of which regulator directly oversees each firm, to the greatest extent possible.

1.2. FAIR Canada supports the requirement that all financial intermediaries, including IIROC dealer members, provide essential financial information to consumers so that consumers are able to answer two basic questions about their investments: (1) What did I pay? and (2) How did my investments perform? Research has shown that investors often do not know the answers to these two fundamental questions.[1] We note that the transition period proposed will mean that this crucial information will not actually get into the hands of Canadian consumers until sometime after July 15, 2016 when the rules come into effect.

1.3. Canadians have become increasingly responsible for ensuring their own financial security in retirement and are required out of necessity to enter into the financial marketplace to invest their savings. When doing so, they face huge asymmetries in the amount of information and resources they possess as compared to financial intermediaries. It is rightly the responsibility of financial intermediaries to provide (and be required to provide) clear, complete, standardized and meaningful information as to what costs the consumer has incurred and how the investment(s) has performed.

2. FAIR Canada's Comments on the IIROC CRM2 Amendments

2.1. FAIR Canada sets out below its specific comments on the IIROC CRM2 Amendments.

a) Pre-Trade Disclosure of Charges

2.2. FAIR Canada supports a formal requirement that a retail customer be informed of all fees/charges associated with a client instruction to purchase or sell a security in an account before the purchase or sale takes place. While this may be a current industry best practice, ensuring that this does in fact occur in all instances by making it a rule is needed and is in compliance with section 14.2.1 of the CSA CRM2 Amendments.

2.3. FAIR Canada recommends that such disclosure, which includes "whether the firm will receive trailing commissions in respect of the security", should include the dollar amount of such trailing commissions. Consumers understand dollar amounts better than amounts expressed in percentage terms. For example, if the trailing commission is 1%, then the disclosure should be that for every $1,000 the trailing commission will be $10.

2.4. FAIR Canada does not accept the suggestion made by RBC Dominion Securities and RBC Direct Investing Inc. in a letter to IIROC dated February 10, 2014 that discount brokerages should not be required to notify consumers/investors who buy investment funds as to whether a trailing commission will be paid to the dealer in respect of the fund purchased. The justification offered by these organizations for not providing the client with this needed information is that "it would be challenging for an order execution-only dealer that provide [*sic*] online platforms to automate its systems to identify whether a specific fund offers trailing commissions." FAIR Canada finds it difficult to believe that such a cost is prohibitive. If disclosing whether a trailing commission will be paid is determined to be too costly, the alternative should be for the firm to rebate any and all

[1] See CSA Notice (2012) 35 OSCB 5430.

trailing commissions received to the client in respect of that fund. As noted in FAIR Canada's submission in respect of CSA Consultation 81-407 Mutual Fund Fees, discount brokerages should offer funds without trailing commissions to their clients given that no "advice" is permitted to be provided.

b) Client Account Statements

2.5. FAIR Canada recommends that IIROC dealer members be required to send monthly account statements to their clients if the client has requested to receive statements on a monthly basis, as is required by section 14.14(2) of National Instrument 31-103. Rule 200.2(d) should be amended accordingly.

c) Performance Reports

2.6. FAIR Canada recommends that IIROC dealer members be required to provide annualized percentage return information for the most recent 1-, 3-, 5- and 10-year periods from account inception, unless the dealer member reasonably believes that the annualized total percentage return for the period before July 15, 2015 is not available, in order to be consistent with the CSA CRM2 Amendments. Registered firms and IIROC dealer members should be required to demonstrate that this information is not reasonably available in order not to provide it. IIROC's rule should not be written so that historic information (i.e. the client's performance history prior to July 15, 2015) need not be provided, as it is currently. IIROC dealer members should make a reasonable effort to provide historical (i.e. prior to July 2015) client performance information to their clients.

d) Fee/Charge Reporting Including Compensation Received From Third Parties

2.7. FAIR Canada recommends that the fee/charge report have a heading for "Compensation we received through third parties" as set out in Appendix D of National Instrument 31-103, in accordance with the CSA CRM2 Amendments.

(i) Definition of Trailing Commissions

2.8. FAIR Canada believes that the definition of "trailing commission" in the CRM2 Proposals, including IIROC Rule 200.1(g), is inaccurate and meaningless to investors. The current definition is as follows:

> ""trailing commission" means any payment related to a client's ownership of a security that is part of a continuing series of payments to a Dealer Member by any party".

FAIR Canada believes that the current definition could capture fees charged under a fee for service relationship (based on assets under management) assuming "any party" can include the client. The definition provided in Appendix B to the CSA Notice and Request for Comments on Proposed Amendments to NI 31-103 published on June 14, 2012 was as follows:

> ""trailing commission" means any ongoing payment to a registered firm in respect of a security purchased for a client that is paid out of a management fee or other charge to the investment."

FAIR Canada is of the view that the earlier definition was better than the current definition. FAIR Canada recommends the definition of "trailing commission" must be improved to enable regulators to ensure compliance with this requirement.

(ii) Purpose of Disclosure of the Trailing Commission

2.9. Disclosure of trailing commissions to consumers is meant to serve two distinct purposes:
(1) consumers need to know how much they have paid for any services they receive, and
(2) consumers need to know if, and how much, their financial services provider is earning in third party commissions in order to begin to be aware of and understand the extent of any conflicts of interests.

2.10. At present, investors have a low awareness of trailing commissions and a low understanding of how trailing commissions influence recommendations made. Consumers have very little understanding about how the advisor they trust to provide them with advice in their interest gets paid. FAIR Canada believes that it is crucial that the nature of such embedded costs is clearly explained to investors, in language they understand, when the amount of trailing commissions is disclosed to them in the fee/charge reporting.

2.11. We believe that the language in IIROC Rule 200.2(g) and in Section 14.17 of the CSA CRM2 Amendments is unclear, confusing and misleading to consumers. It provides:

> "We received $[amount] in trailing commissions in respect of securities you owned during the period covered by this report.
> Investment funds pay investment fund managers a fee for managing their funds. The managers pay us ongoing trailing commissions for the services and advice we provide you. The amount of the trailing commission depends on the sales charge option you chose when you purchased the fund. You are not directly charged the trailing commission of the management fee. But, these fees affect you because they reduce the amount of the fund's return to you. Information about management fees and other charges to your investment funds is included in the prospectus or fund facts document for each fund."[2]

2.12. Clearer language was proposed in an earlier Notice for the cost and performance reporting proposals:

> "The amount of the trailing commissions depends on the sales charge option you chose when you purchased the fund. As is the case with any investment fund expense, trailing commissions affect you because they reduce the amount of the fund's return to you."

The current language is misleading because:

- The trailing commission is charged to the consumer through the MER of the fund. To state that "You are not directly charged the trailing commission or the management fee" is misleading and confusing to consumers. The earlier language was more clear.

[2] Proposed IIROC Rule 200.2(g). Section 14.17(1)(h) of National Instrument 31-103 is substantially the same.

- The payment from fund managers to dealers occurs regardless of whether any ongoing services and advice are provided to the consumer, making it incorrect to state that the "manager pays us ongoing trailing commissions for the services and advice we provide you." Rather, such payments are made so that dealers are compensated for recommending fund manager A's fund to the consumer and for continuing to have the client's holding fund manager A's fund.

- IIROC dealer member rules do not permit discount brokerages to provide recommendations to consumers. Therefore, no "advice" is provided so the statement is misleading.

2.13. FAIR Canada recommends that the trailing commission disclosure language be changed back to the original language and that all third party commissions be disclosed under a separate heading, where it is clearly explained that the dealer received such commissions as a result of sales to that consumer.

3. FAIR Canada's Comments on CSA Staff Notice 31-337 FAQs and Additional Guidance

3.1. CSA Staff Notice 31-337 Cost Disclosure, Performance Reporting and Client Statements – Frequently Asked Questions and Additional Guidance as of February 27, 2014, at Question 2, addresses the client statement and annual report requirements for Exempt Market Dealers ("**EMDs**"). It suggests that EMDs would be required to deliver one account statement with transactional information and would not be required to deliver an annual report on charges and other compensation nor an annual investment performance report where there is only one transaction and there is no "ongoing relationship". FAIR Canada believes that all registrants should be required to provide these reports if the client has incurred charges or costs or if the EMD has received commission payments as a result of the transaction in question.

3.2. FAIR Canada is also concerned that this guidance provides that EMDs are not required to deliver performance reporting information where there is only one transaction and no "ongoing relationship". Absent a requirement for the EMD to provide this information, how will the client obtain it? While we recognize that IIROC does not regulate EMDs, its members likely wish to see these requirements implemented so that all clients (even if not clients of IIROC members) obtain this crucial information.

3.3. Question 3 provides that if the security held by the firm is not a security as defined in securities legislation, then the registered firm will not be subject to any requirement in NI 31-103 for reporting on that investment. FAIR Canada disagrees with this narrow, technical interpretation of a firm's obligations. If the investment is held by the registrant/dealer, we question why the registrant/dealer would not be required to provide reporting on its performance or provide annual charge/fee reporting on the investment. For example, if the firm holds segregated funds for the consumer, should the firm not be required to provide information about its costs and performance? FAIR Canada expects that the insurance regulator would be amenable to such information being provided to clients of segregated funds who hold their segregated funds with securities registrants. We encourage IIROC to discuss this view with the CSA with the goal that the CSA can issue Revised FAQs and Guidance. If the CSA refuses to alter its position, we encourage IIROC to require its member dealers to provide performance and cost reporting in respect of all investments held by the dealer.

3.4. Question 4 provides that short-term trading fees paid to an investment fund must be disclosed in a trade confirmation but are not included in the requirements for the annual report on charges and other compensation. National Instrument 31-103 lists short-term trading fees as an example of a transaction charge:

> "Transaction charges" is also defined broadly in section 1.1 and examples include (but are not exclusive to) commissions, transaction fees, switch or change fees, performance fees, short-term trading fees, and sales charges or redemption fees that are paid to the registrant. Although we do not consider "foreign exchange spreads" to be a transaction charge, we encourage firms to include a general notification in trade confirmations and reports on charges and other compensation that the firm may have incurred a gain or loss from a foreign exchange transaction as a best practice[3].

3.5. FAIR Canada does not understand why such a charge would not be included in the annual report of charges and other compensation. Such charges would decrease the return to the client and should be included. We encourage IIROC to discuss our view with the CSA with the goal that the CSA can issue Revised FAQs and Guidance.

3.6. Question 27 regarding reporting of mutual fund related charges provides that if a security sold by a client triggers a deferred sales charge, but no commission or other payment goes to the registered dealer or adviser, there is no requirement to include it in the annual charge report. FAIR Canada questions how this can be the case given that a deferred sales charge will be a charge incurred by the client that will increase his or her costs and reduce his or her real return. Again, we encourage this issue to be discussed and resolved in favour of fee transparency to the client.

4. Further Reforms Beyond CRM2 Needed to Adequately Protect Consumers

4.1. FAIR Canada commends IIROC and the CSA for moving forward with initiatives such as CRM2 and Point of Sale disclosure for mutual funds (which will be extended to other products such as ETFs). These initiatives have faced opposition by many in the industry, including lobby groups such as the Investment Funds Institute of Canada ("**IFIC**"), and, as a result, have taken a considerable amount of time to come to fruition. Such opponents are now resigned to publicly supporting the benefits of these initiatives and point to them as a reason not to proceed with other much-needed initiatives. For example, the Investment Industry Association of Canada ("**IIAC**"), in its letter to IIROC dated February 10, 2014, argues that additional regulatory measures under consideration (such as the mutual fund risk rating methodology and mutual fund fee reforms) could "unnecessarily jeopardize smooth implementation of all regulatory changes (including CRM2)". FAIR Canada disagrees with the IIAC's position that other needed reforms should be placed on hold pending implementation of CRM2.

4.2. FAIR Canada cautions that the CRM2 Proposals do not address the serious conflicts of interest that impede the development of a healthy, competitive marketplace. The CRM2 Proposals also do not impose a high enough standard to fit the relationship that consumers expect (the full trust and reliance consumers place in and on their advisors) and that the industry professes in much of its marketing and advertising materials. Disclosure in and of itself will not address the serious,

[3] At page 133 of unofficial consolidation.

systemic issues that have been identified. Accordingly, waiting for the CRM2 Proposals to be implemented and further waiting to monitor and assess the effects of the CRM2 Proposals before moving on with other needed reforms would be unjustified and will pose real costs on Canadian consumers. These costs are not important to consumers alone. Ensuring that Canadians have adequate savings for their retirements is an important public policy goal shared by provincial and federal governments. Securities regulators are mandated to foster fair and efficient capital markets and protect investors and action is required now to meet these objectives.

4.3. FAIR Canada notes that other jurisdictions have moved beyond improved disclosure to ban embedded commissions or otherwise impose substantive changes to remove and/or minimize conflicts of interest and misalignment of incentives for financial firms and their intermediaries vis a vis their clients. Australia and the United Kingdom have implemented reforms in the consumer interest; the Council of the European Union has approved new rules; and the U.S. is considering doing so. We urge regulators in Canada to move forward with these needed reforms to address the issues that are cited in the consultations and we have commented on in our recent submissions[4]. FAIR Canada therefore views the CRM2 Proposals as a necessary and important but insufficient step to ensure adequate consumer protection.

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 Neil Gross at 416-214-3408 (neil.gross@faircanada.ca) or Marian Passmore at 416-214-3441 (marian.passmore@faircanada.ca).

Sincerely,

Canadian Foundation for Advancement of Investor Rights

[4] See FAIR Canada's submission on reform of mutual fund fees at http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-comments-re-Mutual-Fund-Fees.pdf and our submission on implemented a statutory best interest standard on dealers and advisers at: http://faircanada.ca/wp-content/uploads/2011/01/FAIR-Canada-Submission-re-CP33-403-Statutory-Best-Interest-Duty.pdf.