

FAIR

Canadian Foundation *for*
Advancement *of* Investor Rights

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Richard J. Corner
Vice President, Member Regulation Policy
Investment Industry Regulatory Organization of Canada
Suite 1600, 121 King Street West
Toronto, Ontario
M5H 3T9
Sent via e-mail to: rcorner@iiroc.ca

Angie F. Foggia
Policy Counsel, Member Regulation Policy
Investment Industry Regulatory Organization of Canada
Suite 1600, 121 King Street West
Toronto, Ontario
M5H 3T9
Sent via e-mail to: afoggia@iiroc.ca

Manager of Market Regulation
Ontario Securities Commission
20 Queen Street West
19th Floor, Box 55
Toronto, Ontario
M5H 3S8
Sent via e-mail to: marketregulation@osc.gov.on.ca

RE: Proposals to implement the core principles of the Client Relationship Model

FAIR Canada is pleased to offer comments on the **Proposals to implement the core principles of the Client Relationship Model** (the “Proposals”) contained in the Request for Comments (the “RFC”) published by the Investment Industry Regulatory Organization of Canada (“IIROC”) on January 7, 2011.

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 of the view that the Client Relationship Model does not go far enough in addressing the needs of investors. The Client Relationship Model represents an incremental improvement to a system of regulation that does not adequately protect investors, where a fundamental rethinking of the framework is needed.
2. FAIR Canada encourages IIROC to adopt a principled Clients First Model in place of the Client Relationship Model. A Clients First Model begins with a fundamental principle regarding client relationships, that a dealer or advisor (a “Dealer Member”) must, in conducting its relationships with retail clients, put the interests of clients first – ahead of the firm’s and the advisor’s interests.
3. FAIR Canada believes that relationship disclosure for retail client accounts should provide more context about the advisor-client relationship and should be made on a consistent, “rolling” basis. It is important that advisors not mislead investors as to the true nature of the relationship through marketing and advertising (including titles used by sales representatives).
4. FAIR Canada believes that advisors must do more than “address” conflicts of interest. Advisors should be required to take reasonable steps to either eliminate the conflict or explain it clearly to the client.
5. FAIR Canada encourages the adoption of a Clients First Model to replace the concept of “suitability” for investments by retail clients; in the absence of this, FAIR Canada encourages a stronger suitability standard including requiring that other factors (including fees) be taken into consideration.
6. FAIR Canada considers that more account performance data should be made available, and that the data should provide more detail (including fees and comparison to benchmarks).

1. FAIR Canada considers that the Client Relationship Model does not go far enough in addressing the needs of investors

- 1.1.** FAIR Canada commends IIROC for its initiative in proposing the Client Relationship Model and the Proposals to implement it, but is concerned that the Client Relationship Model does not go far enough in addressing the needs of investors. In particular, we suggest that the lack of a principled focus to the Client Relationship Model makes IIROC's recommendations less forceful and less protective of investors than a principled model would be.
- 1.2.** FAIR Canada proposes that instead of the Client Relationship Model, IIROC should consider adopting a principle requiring industry participants to put the best interests of their clients first (a “Clients First Model”). This Clients First Model would allow for the development of a standard of conduct that helps to remedy the imbalance in client-firm/advisor relationships.

1.3. FAIR Canada is concerned that the Proposals represent an endorsement of the existing Canadian regulatory framework for dealers and advisors. We are of the opinion that the regulatory framework is not functioning well enough to provide adequate investor protection. For example, investment case files have increased significantly at the Ombudsman for Banking Services and Investments (“OBSI”) in recent years. 2009 saw a 73% increase in new cases over 2008 (according to OBSI's annual report) and a 200% increase over 2006. A recent OBSI release indicated that the last quarter of 2010 saw even more new case files than 2009. Half of the investment cases opened by OBSI in 2009 were related to the suitability of investments, and such cases formed a majority of OBSI's investigations. Failing to meet “Know Your Client” requirements (and thereby failing to understand clients' needs) and failing to properly explain investment characteristics and risks were identified by OBSI as the principal failings in this regard.

1.4. FAIR Canada considers Know Your Client requirements to be basic, fundamental requirements in the client-advisor relationship, yet complaints regarding these fundamental requirements are growing. We believe an overhaul to the current system of regulation is imperative. Canadian retail investors depend on the integrity of the client-financial advisor relationship. **FAIR Canada considers that (1) consumers often believe that those providing investment advice are acting in their best interests; and (2) financial institutions’ and financial advisors’ marketing and advertising also gives consumers the impression that they will provide advice that is in the client's best interests. However, regulatory requirements impose no such standard and advisors and dealers are not held to these standards by regulators. Financial institutions, financial advisors, and regulators support a system which misleads consumers to believe that advisors are required to act in their best interests.**

1.5. FAIR Canada considers that a uniform, national requirement for financial advisors to place their clients' interests ahead of their own and their firm's interests would clarify the client-advisor relationship for all parties, and would provide a much-needed investor protection measure for the financial advisor-client relationship.

2. FAIR Canada encourages IIROC to adopt a principled Clients First Model in place of the Client Relationship Model

2.1. FAIR Canada will provide comments on the particular Proposals within the RFC on the basis of the Client Relationship Model. However, FAIR Canada would also like to encourage IIROC to instead adopt a more sweeping change to the system of regulation of the advisor-client relationship based on the Clients First Model. **The fundamental principle of the Clients First Model would be a general rule stating that, in all aspects of their dealings with their retail investor clients, including recommendations, compensation practices, disclosure, management of conflicts of interest, and all ongoing aspects of the client relationship (such as performance reporting), advisors and dealers must put the interests of clients foremost.**

2.2. The Clients First Model differs from the Client Relationship Model in an important respect. The Client Relationship Model presupposes a business relationship between advisor and client

where each party is able to protect its interests, and seeks to regulate that relationship accordingly for the reasonable protection of advisors and investors. The Clients First Model, on the other hand, rejects the proposition that the relationship between advisor and client is an ordinary business relationship.

- 2.3. Instead, FAIR Canada suggests that the Clients First Model would reflect both what retail investors believe about their advisors and what advisors and financial institutions promote about their services – that in the client-financial advisor relationship the advisor seeks to promote the interests of the client by providing advice that is in the client’s interest. The client is induced by these promotions and by the expertise and skill conveyed by the advisor and relies upon the advisor’s advice. This is distinct from an ordinary commercial relationship, where buyers of services must always beware, and must defend their own interests zealously against those of their fellow participants. Trusted advisors enjoy a special relationship with their clients and can reasonably be expected to uphold the duties that such trust reasonably imposes.
- 2.4. FAIR Canada understands that the Clients First Model will impose a higher standard of conduct on Dealer Members and Approved Persons than that currently in place. However, FAIR Canada urges that it is crucial that Canada not fall behind other jurisdictions in investor protection; the U.S. and the UK have moved ahead of Canada in their initiatives to strengthen investor protections within the client-financial advisor relationship. In the UK in particular, the Financial Services Authority (“FSA”) has adopted a principles-based regulatory regime focused on eleven “Principles for Business” that are themselves regulatory rules.
- 2.5. However, as a cautionary matter, FAIR Canada insists that a principles-based system of regulation does not mean that process-oriented rules should be rejected. (This is arguably the approach taken in the UK by the FSA.) Instead, principles-based regulation should develop process-oriented rules as well as principles that also function as rules. Principles are then the guide and foundation to process-oriented rules, as well as a general protection for investors and a general guide to proper conduct. Therefore, the adoption of a principles-based model should still, in FAIR Canada’s view, include detailed regulation of processes and practices.
- 2.6. In light of the Clients First Model, and based on its general principle that advisors and dealers should put clients’ interests first in their dealings with those clients, FAIR Canada has a number of specific comments on the Proposals.

3. FAIR Canada believes that relationship disclosure for retail client accounts should provide more context about the advisor-client relationship and should be made on a consistent, “rolling” basis.

- 3.1. FAIR Canada stresses that relationship disclosure for retail clients should be made in plain language. It is imperative that this information be provided in language that retail investors can easily understand in order for the disclosure to be meaningful. FAIR Canada supports the Small Investor Protection Association’s (“SIPA”) comment that relationship disclosure must be clear, simple and in plain language.

- 3.2.** It is important that advisors' titles not mislead retail investors as to the nature of the client-advisor relationship. Sales representatives should be called such and should not be permitted to use misleading titles such as financial advisor, managing director, senior vice-president, etc. FAIR Canada endorses Kenmar Associates' recommendation that dealer representatives with no professional affiliations should be identified as salespersons and that confusing titles should not be permitted. SIPA also discusses the problem of misleading titles in their submission on the Proposals.
- 3.3.** In FAIR Canada's opinion, IIROC's Proposal regarding relationship disclosure for retail client accounts adequately sets out the depth of information required for clients to make reasonable decisions about their relationship with their advisor. However, FAIR Canada recommends that IIROC require its members to provide more context to retail clients about the nature of the advisor-client relationship.
- 3.4.** It is not enough to require advisors to present relationship disclosure only upon account opening. An advisor-client relationship may evolve over time; a client may grow in knowledge, confidence, or dependence as the advisor-client relationship grows. FAIR Canada therefore considers it crucial to the success of retail client relationship disclosure that disclosure be renewed on a regular basis.
- 3.5.** In other words, FAIR Canada considers it important that advisors not only provide relationship disclosure to clients, but that they take reasonable steps, on a continual basis, to help those clients understand that relationship disclosure. This includes the continual updating of relationship disclosure, with references back to original documents when changes are made and requirements to offer to explain relationship disclosure to clients who are unclear or uncertain.
- 3.6.** In particular, FAIR Canada considers subsection XX04.1(c) of this proposal, allowing general descriptions and references to other disclosure materials, to be unacceptably vague. Allowing advisors to make their relationship disclosure materials a maze of cross-references to other documents is not helpful to investors.
- 3.7.** In particular, FAIR Canada considers that rule XX04.2 of this proposal, allowing relationship disclosure to be incorporated into other account opening materials, would allow relationship disclosure to be buried among other material. FAIR Canada views a strong emphasis on the importance of relationship disclosure to be crucial to investor protection.
- 3.8.** **If the Clients First Model or its equivalent is not adopted as a fundamental guiding rule for the financial advisor-client relationship, advisors should be required to alert their clients about the actual rights they have as an investor, vis-a-vis their advisors, and the actual legal obligations of dealers regarding KYC requirements, suitability requirements and conflict of interest situations. As part of the relationship disclosure for retail client accounts, this disclosure should explain clearly the difference between these obligations and a "best-interests" obligation, and should explain to investors how they can safeguard and enforce their rights regarding conflicts of interest, and KYC and suitability obligations.**

3.9. FAIR Canada has previously recommended to IIROC, in a recent response to IIROC's Request for Comments on its Plain Language Rule Re-write project *Dealing with Clients*, that such disclosure, which clearly sets out the rights of investors and the actual duties of advisors, be prepared by IIROC and written in readable, plain language. FAIR Canada believes that this is the best way to ensure that such disclosure be accurate and complete. In the absence of such a project, FAIR Canada urges IIROC to require advisors to draft such language as part of the relationship disclosure.

4. FAIR Canada believes that dealers and advisors must do more than “address” conflicts of interest.

4.1. FAIR Canada considers the Clients First Model to provide an important principled approach to the handling of conflicts of interest. The Proposals suggest that advisors may deal with conflicts of interest by “addressing” them in “a fair, equitable and transparent manner” and “considering” clients' best interests.

4.2. FAIR Canada considers this to be an unacceptably low standard for dealing with conflicts of interest, which again contrasts our proposed Clients First Model with the Client Relationship Model.

4.3. The Proposals, and the Client Relationship Model, propose to regulate conflicts of interest by seeking a “fair” means of addressing the conflict, “equitable” between the Dealer Member or Approved Person and the client. FAIR Canada considers this to be a prime example of the “business relationship” model of regulation that, in our opinion, has failed and continues to fail investors.

4.4. Retail clients depend and rely on advisors for advice they cannot otherwise obtain, lacking the expertise and experience of advisors. There is an inherently unequal relationship between a client and his or her advisor, resulting in the client being placed in a position of vulnerability relative to the advisor. Seeking an “equitable” ground between their interests may mean that clients will not be protected.

4.5. The adoption of a Clients First Model would provide a new and more principled approach to the relationship of trust and reliance between client and advisor. **Rather than requiring that advisors “address” conflicts of interest with clients, a Clients First Model would encourage advisors to take reasonable steps to eliminate conflicts of interest with clients. Where such conflicts of interest cannot be eliminated, advisors would be required to: explain the conflict to the client; offer to assist the client in understanding the nature and ramifications of the conflict; and, where necessary, advise the client to obtain third-party advice.**

4.6. In particular, whether or not a Clients First Model for regulation is adopted, FAIR Canada considers proposed rule XX04.1 to be inadequate. FAIR Canada considers it important for conflicts to be disclosed not only at the outset of a client relationship, but also to be the subject of continual client education by advisors. FAIR Canada considers that conflicts of

interest be made an integral part of the relationship disclosure materials we discuss in section 3.

4.7. In particular, FAIR Canada notes that the Proposals at Rules XX02 and XX03 require only that Approved Persons and Dealer Members “address” conflicts of interest. This is inadequate to provide sufficient protection for investors. According to the RFC, IIROC staff made this change to clarify that conflicts need not be resolved. It is important that Approved Persons and Dealer Members take reasonable steps to attempt to resolve conflicts of interest with their clients. Where conflicts cannot be resolved, FAIR Canada agrees that complete disclosure of the conflict and explicit approval from a client can be of assistance. FAIR Canada would prefer to see this made explicit in the proposed Rules. FAIR Canada therefore suggests that the Rules should state that where conflicts under Rule XX02 or XX03 cannot be resolved, that conflict may be dealt with through disclosure under Rule XX04, and that this is sufficient to satisfy the dealer’s obligations.

5. FAIR Canada encourages the adoption of a Clients First Model to replace the concept of “suitability” for investments by retail clients; in the absence of this, FAIR Canada encourages a stronger suitability standard.

5.1. FAIR Canada commends IIROC on its move to strengthen the suitability requirements for retail investors by expanding the factors to be considered by advisors in determining suitability.

5.2. However, in keeping with our Clients First Model, FAIR Canada agrees with Kenmar Associates’ comment that there is a fundamental issue with suitability being the core criterion in providing investment advice. FAIR Canada does not consider “suitability” to be a satisfactory concept for advisors to apply to retail investment recommendations.

5.3. In any case, FAIR Canada considers it important to list further specific considerations necessary to the determination of suitability.

5.4. FAIR Canada’s suggestion of a Clients First Model incorporates a standard of investment recommendation that is more appropriate to the client-advisor relationship than mere suitability. Where an advisor is required to put his or her client's best interests first, that advisor's recommendations should not only be “suitable” for the client, but should be formulated with the client's best interests in mind, taking into account all of the enumerated factors which are currently used (and are proposed to be used) to determine suitability.

5.5. In other words, FAIR Canada believes that the suitability requirement should be supplanted by a requirement that the recommendation (to purchase, sell, exchange or hold) be, in the reasonable opinion of the advisor, in the client's best interests. That opinion, FAIR Canada believes, should take into account at least all of the enumerated factors.

5.6. FAIR Canada appreciates the extensive list of factors that IIROC has proposed as relevant to suitability, enumerated in Rule 1300.1(p) and 1300.1(q), and would suggest that two additional factors be included in the list.

5.6.1. **Fees** - FAIR Canada considers it important that advisors be required to consider the fees payable as a result of buying, selling, exchanging or holding a security, in determining suitability (or in determining whether such a purchase or sale is in a client's best interests).

5.6.2. **Client-Specific Characteristics** - Although FAIR Canada considers the specific requirement to consider such enumerated factors to be important and appropriate, we are concerned that the enumeration of such factors is not sufficient in order to properly identify to both investors and advisors all the elements to be considered in determining whether an order or recommendation is suitable. Furthermore, we consider the addition of these particular enumerated factors to create the dangerous appearance of completeness, when in fact there are many other specific factors that determine suitability. FAIR Canada would therefore propose additional language in proposed subsections 1300.1(p) and (q), reading “in addition to all the client's other relevant characteristics.”

6. FAIR Canada considers that account performance data should be made available at a much finer level of detail.

6.1. FAIR Canada commends IIROC's efforts to ensure that account performance reporting be made available to clients by advisors. FAIR Canada considers security position cost disclosure, account activity disclosure, and account percentage return disclosure to be important information to assist investors in assessing their financial situation, as well as the performance of their investments and their advisors. A Clients First Model places a great deal of importance on the quantity and quality of information made available to investors, to enable them to better understand their financial position, make informed choices and communicate those choices to their advisors. Advisors who put their clients' interests first will seek to communicate as much information as possible regarding the performance of their clients' investments, and their implications in a way that is meaningful to their clients.

6.2. FAIR Canada recommends that IIROC require (or move towards requiring) three crucial classes of information overlooked in the Proposals.

6.3. Fee Disclosure - First, FAIR Canada considers it important that advisors provide information regarding fees paid to acquire and sell investments, as part of client account cost reports, cumulative account performance information, and account annualized compound percentage return information. **FAIR Canada considers fees to be a crucial component to understanding an investment and without understanding the fees that are being paid (to the advisor or otherwise) or what they are paying for the services of the Dealer Member and advisor, clients will not be able to make informed financial decisions.**

6.4. In particular, FAIR Canada considers that

(1) client account cost reports under Rule 200.1(d) should break out fees payable on acquisition (or subsequently) along with cost information; and

(2) cumulative account performance information under Rule 200.1(e) should also break out fees payable on acquisition and disposition of securities listed.

6.5. Benchmarks - Second, FAIR Canada considers it important that advisors provide benchmarks to which annualized compound percentage return information can be compared. We support SIPA's suggestion that client statements indicate an annualized rate of return and compare it to an appropriate benchmark. FAIR Canada is not suggesting particular benchmarks, in the abstract, to be more appropriate than others but considers it important for IIROC to require advisors to provide an appropriate context for percentage return numbers provided to clients.

6.6. Performance of Specific Investments - Third, although it may not be practical to require advisors to immediately implement such a system, FAIR Canada submits that it would be appropriate to require annualized compound percentage return information for each position within a client's account. This information could be included either as part of the client account cost reports required under Rule 200.1(d) or as part of the information for accounts under 200.1(f).

6.7. Information about individual positions is crucial to investors because it is the aggregate of their individual positions that determines their financial future. If a compound percentage return is to be provided for an account, FAIR Canada sees no reason why it should not be provided for each position within that account. Such information puts the clients' interests first, allowing them to see much more clearly their financial position and allowing them to evaluate performance of both investments and advisors in a much more detailed and informed way.

6.8. XBRL - In order to assist this evaluation, it is important for IIROC to require dealers to make all of these reports and information available to clients in a format that is easily machine-readable, to allow computers to help clients understand them. These may be financial tools available now, or tools that may come available later. In order to facilitate this, FAIR Canada encourages IIROC to require that such information be made available to clients in an extensible mark-up language format such as XBRL (eXtensible Business Reporting Language). IIROC, if necessary, should help to implement a standard for such reporting.

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 416-572-2282/ ermanno.pascutto@faircanada.ca or Ilana Singer at 416-572-2215/ ilana.singer@faircanada.ca.

Sincerely,

Canadian Foundation for Advancement of Investor Rights