BMO Financial Group

BY ELECTRONIC MAIL: jstevenson@osc.gov.on.ca, consultation-en-cours@lautorite.qc.ca

February 22, 2013

Alberta Securities Commission
Manitoba Securities Commission
Ontario Securities Commission
Autorité des marchés financiers
New Brunswick Securities Commission
Nova Scotia Securities Commission
Superintendent of Securities, Nunavut
Financial and Consumer Affairs Authority of Saskatchewan
Registrar of Securities, Prince Edward Island
Superintendent of Securities, Newfoundland and Labrador
Superintendent of Securities, Northwest Territories
British Columbia Securities Commission
Superintendent of Securities, Yukon

Attention:

John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West,
Suite 1900, Box 55
Toronto, ON
M5H 3S8

Me Anne-Marie Beaudoin
Corporate Secretary
Autorité des marchés financiers
800, square Victoria, 22e étage
C.P. 246, Tour de la Bourse
Montréal (Québec)
H4Z 1G3

Dear Sirs / Madames:

Re: Canadian Securities Administrators (the 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)

BMO Investments Inc., BMO InvestorLine Inc., BMO Nesbitt Burns Inc., BMO Harris Investment Management Inc., and BMO Asset Management Inc. (the **BMO Registrants,** or **we**) welcome the opportunity to provide comments on the Consultation Paper.

We are committed to delivering comprehensive high quality professional investment services to clients of all levels of income, investment knowledge, and service needs. This is demonstrated by the wide selection of services and products that we offer, including adviceDirect®, an innovative online full service trading platform. The BMO Registrants include securities dealers that are members of the Investment Industry Regulatory Organization of Canada (**IIROC**), a mutual fund dealer that is a member of the Mutual Fund Dealers Association of Canada (**MFDA**), investment fund managers, an exempt market dealer and portfolio managers. As such, we are in a unique position to consider the effect of the proposed conduct standard from the position of a product manufacturer, underwriter, distributor, and adviser.

We have a strong culture of compliance that is governed across Bank of Montreal and its subsidiaries, by First Principles, our code of conduct. We have a proven record of creating innovative compliance tools such as On-Trac, the first automated suitability tool for dealers and compliance staff.

Industry Association Comment Letters

We have been involved with the Investment Industry Association of Canada and Investment Funds Institute of Canada comment letters. We are in substantial agreement with the comments made by these industry organizations.

Summary

While we support the general investor protection objectives in the Consultation Paper, we are concerned that a statutory fiduciary standard is not the ideal "Made in Canada" tool to achieve those objectives. Recently, a number of targeted policies have been created to address similar concerns, the complete implementation of which has not yet commenced. As discussed below under the heading "Client Relationship Model", we believe a statutory fiduciary standard should not be considered until after the securities industry has implemented the Client Relationship Model (**CRM**) and the CRM has had enough time to achieve its objectives.

We are concerned that the introduction of a statutory fiduciary standard may give rise to unintended consequences. A great deal of effort went into creating the CRM, a comprehensive, dynamic and uniform approach to client and dealer relationships. We believe that the benefits of completing the CRM implementation process and evaluating its success exceed the potential benefits, if any, and the probable costs of introducing a statutory fiduciary standard at this time.

Part 1: Client Relationship Model

Canada is in an enviable position from a regulatory perspective in that many of the issues faced by regulators in other jurisdictions have already been considered or addressed by the CSA, IIROC and the MFDA over the past decade. Since 2004, the Ontario Securities Commission and the CSA have considered a comprehensive set of regulations and policies covering all aspects of the relationship between registered dealers[1], their clients, and the products sold to those clients. The Fair Dealing Model[2] requires that dealers and advisers clearly articulate to their clients, the fees charged, the conflicts of interest that may arise, and the services to be provided. The Fair Dealing Model was reviewed by stakeholders in Ontario and eventually was considered on a national scale by the CSA, MFDA and IIROC in the form of the CRM. In this regard, the CRM is a Canadian solution to investor protection concerns that are similar to the ones identified in the Consultation Paper and was an

1 In this comment letter, the term "adviser" refers to adviser firms registered under the Securities Act (Ontario) as portfolio managers and individuals employed by those firms that are registered as advising representatives, and the term "dealers" refers to dealers registered under the Securities Act (Ontario) as an investment dealers, mutual fund dealers or exempt market dealers and individuals employed by those firms that are registered as dealing representatives.

2 OSC Concept Paper 33-309 *The Fair Dealing Model* (1994).

innovative attempt by a securities regulator to address these concerns. The CRM builds on Canada's unique regulatory scheme and reflects the varied business and client relationships that exist in our marketplace.

The CRM is contained in National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations* (**NI 31-103**), MFDA Rules[3], and IIROC Rules[4]. Full implementation of the CRM is scheduled to take effect on March 26, 2014[5] for IIROC members and is scheduled to take effect on December 3, 2013 for MFDA members. Many of the CRM's core principles have applied to all other registered dealers and advisers since 2009. The core features of the CRM for IIROC Members are:

- Improved account relationship disclosure (the **Relationship Disclosure**);
- Enhanced suitability assessments with new triggers to ensure portfolios are reviewed whenever a client's circumstances or markets change materially (the **Enhanced Suitability**);
- Conflict of interest management disclosure (the **COI Management**); and
- Personal Cost of Investment and Investment Performance Disclosure (the **Personal Cost and Performance Disclosure)**.

The Consultation Paper lists several investor protection concerns as the basis for the proposed changes, which we have for convenience summarized as:

- A need to establish a principled foundation for registrant conduct (the **Principled Foundation**);
- The lack of understanding by investors of their investments and the services received (the **Comprehension Gap**);
- A difference between the services expected and the services received (the **Service Expectation Gap**);
- The purported difference between suitable recommendations and a best interests standard (the **Suitability Gap**); and
- The purported inadequacy of the current conflict of interest rules (**Conflict Management**).

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3 MFDA Rules 2.2.1, 2.2.4, 2.2.5, and 2.8.3, and MFDA Policy No. 2 *Minimum Standards for Account Supervision.* Implementation of MFDA Rule 5.3.5 has been suspended pending harmonization with CSA's performance reporting requirements (see footnote 5 below)

4 IIROC Rule 3500, and IIROC Rule 42. Implementation of IIROC Rule 1300 has been deferred (see footnote 5 below)

5 Implementation of Account Performance Reporting of CRM has been deferred until the CSA's performance reporting requirements, currently under review by the CSA, have been completed. The comment period for the proposals closed on September 14, 2012.

Securities legislation in Canada imposes a duty on registered advisers and dealers to deal fairly, honestly and in good faith with their clients[6]. Existing securities legislation has a robust set of conduct rules that go well beyond the requirement that a trade recommendation is suitable for the client[7]. The CRM builds on those requirements. Under NI 31-103, registered firms must identify conflicts of interest and where a reasonable investor would expect to be told of the conflict, inform the client of the nature and extent of the conflict of interest.[8] IIROC Rules require that registered securities dealers and their trading employees:

a) address all existing or potential material conflicts of interest in a "fair, equitable and transparent manner, and consistent with the best interests of the client or clients"; and

b) avoid "any existing or potential material conflict of interest . . . that cannot be addressed in a fair, equitable and transparent manner, and consistent with the best interests of the client".[9]

The CRM and the other codes of conduct demonstrate the Canadian securities markets are regulated with comprehensive, principled and detailed rules that we believe address investor protection concerns and do not create a "buyer beware" system. These regulations demonstrate that Canada's securities industry is founded on principled and prescriptive rules and demands that its members meet high standards of ethical conduct and fair and honest dealings with their clients.

(a) The Client Relationship Model is the "Made in Canada" Solution for Canadian Markets

We believe that the Consultation Paper attempts to address a series of policy concerns using non-Canadian solutions that have either not been fully implemented in those foreign jurisdictions, or were designed to address different issues that are not present in Canada. In contrast, after considerable review, the CRM was designed by Canadians for the needs and expectations of Canada's investors and markets.

The five investor protection concerns raised by the Consultation Paper are addressed by the CRM and other CSA Initiatives as follows:

Consultation Paper Concerns	Client Relationship Model Solutions	Other CSA Initiatives
1. Principled Foundation	COI Management	
2. Comprehension Gap	Personal Cost and Performance Disclosure	Management Report of Fund Performance

6 See section 2.1 of Ontario Securities Commission Rule 31-505 *Conditions of Registration.*

7 Section 13.3 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations.*

8 Section 13.4 of National Instrument 31-103 *Registration Requirements, Exemptions and Ongoing Registrant Obligations.*

9 IIROC Rules 42.2 and 42.3.

Consultation Paper Concerns	Client Relationship Model Solutions	Other CSA Initiatives
		Fund Facts Document CSA Sponsored Investor Education
3. Service Expectation Gap	Personal Cost and Performance Disclosure Relationship Disclosure	
4. Suitability Gap	Enhanced Suitability	
5. Conflict Management	COI Management	

(i) The CRM, Comprehension Gap and Service Expectation Gap

Other recent CSA initiatives, including Fund Facts Documents and Management Reports of Fund Performance for mutual funds, also deal with any Comprehension Gap. Investment analytical tools, the proliferation of financial media outlets, access to professional research reports and CSA investor education initiatives also address any Comprehension Gap.

Personal Cost and Performance Disclosure and Relationship Disclosure should help clients and their dealers define their relationship, have a discussion regarding the cost and value of the services provided, and ultimately narrow any Service Expectation Gap. If clients do not understand their relationship with their adviser or dealer, the application of a fiduciary standard does not necessarily narrow the Service Expectation Gap.

There is a clear connection between the CRM and the desire that clients understand the cost of the services and products recommended, the services received for the fees paid and the performance of their investments. Focussed and relevant information from dealers should help clients achieve a deeper understanding.

(ii) The CRM and the Suitability Gap, Conflict Management and Principled Foundation

The CSA's concern with the Suitability Gap is based on the premise that a:

> dealer may be tempted to select a "suitable a product that is not necessarily the best one for the client . . . [resulting] in investors acquiring a "suitable" investment but at an inflated price[10]

Implicit in this premise is that two or more products exist that are exactly the same other than the "inflated price" of the recommended product. In this hypothetical scenario, we have assumed that the CSA is primarily concerned that a conflict of interest may be the sole reason why a dealer may choose to recommend a product that is suitable but inflated when compared to a highly similar product. Under the CRM, a conflict of interest must be addressed in a "fair, equitable and

[10] CSA Consultation Paper, page 9581.

transparent manner, and consistent with the best interests of the client or clients" and IIROC dealers must avoid "any existing or potential material conflict of interest . . . that cannot be addressed in a fair, equitable and transparent manner, and consistent with the best interests of the client". Addressing the conflict of interest in a manner that is "consistent with the best interest of the client" is a principled approach.

According to the Consultation Paper, the CSA's Conflict Management concerns are based on CSA staff's normal course compliance reviews where they found that:

> some firms narrowly interpret the current principles-based regulatory approach for dealing with conflicts of interest such that they (i) fail to appropriately identify and respond to conflicts or (ii) rely too heavily on disclosure (especially where the disclosure may be meaningless for the client)[11]

The above excerpt from the Consultation Paper demonstrates the need for: (i) compliance audits by CSA members; and (ii) enforcement or refinement of existing rules. It is unclear how, as a policy initiative, changing the principled regulatory approach with another principled regulatory approach will improve the interpretation of a principle.

Conflict Management concerns raised by the CSA included embedded fees in mutual funds and the sale of related and connected issuers by dealers. The CSA has published a Discussion Paper which considers policy options for dealing with embedded fees[12], and noted in the Consultation Paper that prescriptive rules may be considered regarding the sale of related and connected issuers by dealers. It is unclear why the introduction of a statutory fiduciary duty is needed before full consideration of these other prescriptive initiatives is complete.

The CSA's Principled Foundation concern is based on the view by some commentators that Canadian capital markets are a "buyer beware" system supported by prescriptive prohibitions and key disclosures.[13] This view does not reflect the proactive, measured and thoughtful approach the CSA has taken towards regulating client relationships since 2004. As discussed above, Canada's capital markets are premised on the principle that all advisers and dealers must act towards their clients fairly, honestly, and in good faith. The CRM's COI Management provisions require that dealers address, manage, and in certain circumstances, avoid conflicts of interest. Before determining what, if any, additional changes should be made to the principles that govern and the conflict management rules that exist, the CRM should be implemented and evaluated.

It appears that some of the investor protection concerns raised by the Consultation Paper were based on the regulatory landscape before the CRM's full implementation as well as issues addressed or to be addressed by other CSA policy initiatives. We believe that any conclusions regarding such concerns

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11 CSA Consultation Paper, page 9581.

12 CSA Discussion Paper and Request for Comment 81-407 *Mutual Fund Fees* dated December 13, 2012.

13 CSA Consultation Paper, page 9579.

should be supported by empirical evidence obtained after the CRM's implementation is complete in order to determine whether further action, if any, is warranted.

(b) A Fiduciary Duty is a Legal Concept based on Facts

Supreme Court Justice LaForest stated in the Lac Minerals[14] case that "[t]here are few legal concepts more frequently invoked but less conceptually certain than that of the fiduciary relationship". This statement highlights the reserve that ought to be applied in extending the fiduciary relationship to new contexts. As discussed below, without substantial modification and restrictions, some but not all of which were described in the Consultation Paper, the application of a statutory fiduciary relationship may interfere with existing business models which are essential to Canada's capital markets.

There are many different forms of client relationships and each one has s different level of vulnerability, trust, reliance and discretionary authority (the **Fiduciary Factors**). At common law and in any alternative dispute resolution process, the trier of fact has the opportunity to determine whether or not the Fiduciary Factors exist in the client relationship and as a result whether the relationship is fiduciary in nature. Under the CRM, the client relationship is clearly disclosed. As part of the CRM, IIROC Rule 3500.2 – *Relationship Disclosure* requires that the dealer explain at the outset (and when there is a material change) the kind of relationship they have with the client. IIROC Rule 3500.2 lists three categories of client relationships:

(i) "**advisory accounts**" – where the client is responsible for investment decisions but is able to rely on advice given by a registered representative – these are often referred to as full service brokerage accounts;

(ii) "**order-execution service accounts**" – where the client makes all the investment decisions and the dealer is only required to execute the trade - these include discount brokerage accounts; and

(iii) "**managed accounts**" – where the client has put his or her full trust and reliance on the dealers discretion and as a result the client is vulnerable to the dealer – these are the equivalent of discretionary separately managed accounts.

Clients use investment services in various ways including ones that may give rise to a fiduciary relationship. Therefore, it would not be appropriate in all circumstances to impose a fiduciary relationship on a client relationship where the Fiduciary Factors do not actually exist. For example, some retail clients of full service brokers are very sophisticated and want to have an opportunity to do their own research and work collaboratively with their registered dealer to make an investment decision – this type of client may not even have all of their investments with the same full service dealer. Other retail clients may be inexperienced and rely on their full service dealer for tailored advice that is designed to be part of a comprehensive financial plan. Another type of retail client may only want to be contacted for initial public and structured product offerings and may keep only a small portion of their

[14] Lac Minerals Ltd. v. International Corona Resources Ltd., [1989] 2 S.C.R. 574.

investable assets with that dealer. Each client has different expectations of his or her dealer's services which reflect that relationship. Once the CRM is fully implemented, it will be clearer as to when the Fiduciary Factors are or are not present. As a result, the Expectation Gap should narrow considerably.

The Relationship Disclosure provisions of the CRM will apply to all clients of IIROC members on March 26, 2014, will apply to all clients of MFDA members on December 3, 2013 and has been in place since 2009 for dealers and advisers who are not members of IIROC or the MFDA. We believe that before considering whether these investor protection concerns can be addressed by a statutory fiduciary duty, we must first determine whether the CRM adequately addresses these issues.

Part 2: Potential Consequences of a Fiduciary Standard

We are concerned that unintended consequences may arise should the CSA introduce a statutory fiduciary standard.[15] We have considered the potential consequences from the perspective of a "typical" adviser or dealer and the following is not necessarily a description of how the BMO Registrants currently intend or expect to conduct themselves.

(i) *Defensive Trade Recommendations*

In order to ensure that a recommendation is demonstrably defensible, some dealers may choose to make recommendations that they believe are less likely to give rise to litigation or liability. This may have the unintended consequence of reducing capital raising opportunities for many new issuers and restrict client access to novel or innovative products.

(ii) *Advisory Accounts*

The Consultation Paper suggests that, at common law, advisers' and dealers' discretionary accounts generally give rise to a fiduciary duty. Generally, discretionary accounts have higher fees and minimum account levels than advisory accounts and have higher compliance and supervision costs. If the compliance and supervision model for discretionary accounts is applied to advisory accounts, the cost of maintaining these accounts will increase. As the cost of compliance and compliance increases, some dealers may choose to absorb higher costs, increase the minimum size for clients' advisory accounts and/or increase fees on advisory accounts. If advisory accounts have similar fees and minimum account requirements as discretionary accounts, it follows that: (a) some clients may be unable to find dealers willing to service smaller advisory accounts and those clients will have to migrate to order-execution only accounts; and (b) some clients may choose to move to discretionary accounts given the similar cost and other factors described in this Part.

[15] For the purpose of this comment letter, we have considered the best interest standard described on page 9583 of the Consultation Paper together with the conditions outlined under the heading "General Scope" that follow.

(iii) *Regulatory Arbitrage to Non-Securities Distribution Channels*

If the cost of advisory accounts becomes too high or the recommendations of dealers become too restrictive, clients and those who provide them with financial services may seek non-securities distribution channels.

(iv) *Increased Cost of Advice and Litigation*

As discussed above, additional compliance, and supervisory requirements will be necessary if a statutory fiduciary standard is imposed. Given the courts have not provided a clear definition of this standard or the applicable civil or common law remedies, the length and cost of litigation will increase. There is also a risk of greater damages awards which could drive litigation costs even higher. As discussed above, these factors could cause dealers' advice to become more defensive, result in increased client costs and reduce the options available to investors.

Conclusion

We believe that it is premature at this point to consider the purported deficiencies of the current regulatory regime before the implementation of the CRM. The CRM, a major reformulation of registrant conduct, is not yet fully in force and the evaluation of its effectiveness has not yet begun. The proposed statutory fiduciary standard in the Consultation Paper may result in unintended consequences, the effects of which are unclear. Considering that each of the investor protection concerns listed in the Consultation Paper are being addressed by one or all of the core features of the CRM, we are of the view that allowing the CRM to be implemented, tested and refined is the surest way to ensure that investor protection is balanced with market efficiency.

We appreciate the opportunity to provide our comments on the Consultation Paper and, as always, look forward to providing any assistance to the CSA in its continued efforts to ensure that investors are protected and markets function efficiently.

Yours very truly,

(signed) "Darcy Lake"

Darcy Lake
Chief Compliance Officer
BMO Private Client Group