TO:

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
Fax: 514-864-6381
e-mail: consultation-en-cours@lautorite.qc.ca

John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario
M5H 3S8
Fax: 416-593-2318
e-mail: jstevenson@osc.gov.on.ca

COMMENTS ON CSA Consultation Paper 33-403

PREPARED BY DAVID STANLEY

ON BEHALF OF THE CANADIAN SHARECLUBS

SUBMITTED 12/27/2012

MAJOR RECOMMENDATIONS

1. THAT A TWO-TIERED SYSTEM BE INTRODUCED IN WHICH AN UPPER ECHELON OF ADVICE GIVERS TERMED 'INVESTMENT ADVISORS' WOULD HAVE A FIDUCIARY DUTY TO THOSE CLIENTS REQUIRING IT, AND A LOWER TIER TERMED 'DEALER REPRESENTATIVES' WHO WOULD NOT BE ALLOWED TO ADVISE CLIENTS WITH WHOM A FIDUCIARY DUTY IS REQUIRED.
2. THE PRESENCE OR ABSENCE OF A FIDUCIARY DUTY STANDARD WOULD BE AGREED TO JOINTLY AND IN WRITING BY THE INVESTMENT ADVISOR AND POTENTIAL CLIENT AT THE OUTSET OF THEIR RELATIONSHIP.

I. INTRODUCTION

I am David Stanley, Organizer of the Guelph ShareClub and Contributing Editor of the Canadian MoneySaver magazine. I welcome the initiative taken by Canadian Securities Administrators in circulating a white paper and asking for replies to "The Standard Of Conduct For Advisers And Dealers". A draft of the response contained herein was circulated to the 36 affiliate ShareClubs in Canada, representing over 1000 independent investors, for their comments and approval.

It would be appropriate to acquaint readers with the ShareClub movement in Canada. The ShareClub concept was devised by Mr. Dale Ennis, the founder and first editor of the Canadian MoneySaver magazine. The MoneySaver was founded in 1981 by Mr. Ennis in order to provide unbiased financial advice to individual Canadian investors. In 1997 Mr. Ennis conceived ShareClubs as a way to empower investors at a local level through members sharing their knowledge and experience with each other. ShareClubs are not investment clubs; members control their own financial affairs and investment decisions. No dues are involved and all the organizational work is done on a volunteer basis. Subscribing to the MoneySaver is not a prerequisite to membership. ShareClubs provide a venue where investment strategies, prior mistakes, and future decisions can be discussed in a supportive environment.

We are the only Canadian not-for-profit grassroots individual investor organization, and, as such, feel fully qualified to reply to the CSA white paper on behalf of our members. The reason we as a group have decided to produce this submission is simply because so many of our members, as well as many other Canadians, have suffered at the hands of unscrupulous securities dealers. Examples will be provided in the Appendix at the end of this document. In fact, many members find their way to the ShareClub because they have incurred financial losses at the hand of their advisors. The consumers of financial products need to be involved in the debate of how to fix the financial industry. We believe that the status quo is not acceptable, cannot continue, and that reasonable points of view cannot be ignored.

II. STATEMENT OF THE PROBLEM

Investing, particularly in equities has, until quite recently, been a proven way to build wealth and retirement savings. Thus, it is not surprising that an increasing number of Canadians have turned to investing in stocks and bonds as a way to increase their financial well-being. Those with significant disposable income but relatively little investment experience have often chosen to engage the services of investment advisors (an investment advisor means a person or company engaging in the business of advising others as to the investing in or the buying or selling of securities) to either help them with choosing investment products or to entirely control the investment process.

Many have regretted this decision. The most common complaints heard in ShareClub meetings include frustration with low returns compared to the market as a whole, being gouged by high fees, portfolio churning, front running, lack of contact with their advisor, being sold inappropriate products, nondisclosure of all the risks and potential loss related to a product, and continued sales pressure from their advisors. In short, they felt their advisor's interests were not aligned with their own. Trust, the most necessary ingredient in a wholesome client-advisor relationship, was missing. Some of these grievances went far beyond simple dissatisfaction, as may be seen in the Appendix. ShareClub enrollment continues to swell in Canada; this could mean that increasing numbers of investors are becoming disillusioned with their advisors and wish to gain the knowledge necessary to handle their own financial affairs.

When individual investors have been defrauded by advisors they rarely are able to recoup the losses. Existing regulations make it difficult to achieve restitution, and penalties for miscreants are minimal and very rarely involve criminal charges.

It seems likely that the complaints and enforcement failures mentioned here have led to the current state of affairs where both investors and regulators are demanding changes in the advisor-client contract.

III. THE CURRENT STATUS OF INVESTMENT ADVISORS REGARDING FIDUCIARY DUTY

Regulation of Canadian investment advisors is currently a mélange of self-regulation through professional organizations including the Investment Industry Regulatory Organization of Canada (IIROC) and the Mutual Fund Dealers Association of Canada (MFDA), thirteen provincial and territorial securities commissions such as the Ontario Securities Commission, and the notable absence of a unified federal presence. The Canadian Securities Administrators is the umbrella organization for Canada's provincial and territorial securities regulators. Additionally, not-for-profit organizations provide educational materials and act as lobbyists for different groups of stakeholders.

Stock brokers (often called ‘investment advisors’) are primarily concerned with the buying and selling of stocks, while financial planners (regulated by the MFDA) are not stock brokers but deal mainly in mutual funds. However, all these dealers have an obligation to consider the general investment needs and objectives of their clients as well as the suitability of any proposed purchase or sale of securities. The suitability of an investment recommendation is based upon the ‘Know Your Client’ concept. Thus, investment advisors have an obligation to learn about their clients, their personal financial situation, financial sophistication and investment experience, investment objectives and both risk tolerance and risk capacity.

It is important to realize that for many years the Canadian courts have recognized that the investment advisor-client relationship may be fiduciary in nature. Investment advisors are considered professionals who have acquired extensive training and knowledge in the area of investments, while retail clients (those who receive personalized investment advice about securities from an investment advisor and use that advice for only personal, family, or household purposes) are generally less knowledgeable Thus, there is usually some degree of trust and reliance by the client on the advisor, and a fiduciary relationship may exist. The determination depends to a large degree upon the nature of this relationship and the knowledge and experience of the investor. The more dependence the client has on the advisor the more likely it will be that the relationship will be a fiduciary one.

Whether or not the investment advisor's relationship is fiduciary determines the degree of responsibility involved. If no fiduciary relationship is in effect the duty of the advisor is to exercise the standard of care equal to that provided by a reasonable and prudent advisor in similar circumstances. On the other hand, a fiduciary's responsibility is to act consistently for the client's interests and not to betray the trust out of self-interest.

The relevance of the fiduciary determination is that if it does exist and is subsequently broken by the advisor then more serious penalties and damages may be levied. It is apparent that a broad spectrum of advisor-client relationship are possible and that determination of the presence of a fiduciary duty must rest in the hands of an expert in this type of law. Thus, currently the relationship of broker and client is not per se a fiduciary one and must be adjudicated on a case by case basis.

IV. A POTENTIAL SOLUTION AND ITS ADVANTAGES

One way to improve the current situation would be to force all advisors to practice 'fiduciary duty' with respect to their clients. Any breach of fiduciary duty could then lead to legal liability and concomitant consequences.

Fiduciary duty is a legal term and is thus open to several interpretations depending upon its application, venue, and jurisdiction. A commonality of usage of the word is that a fiduciary has a legal duty and obligation to act in the best interests of someone else, putting their own interest aside. It is in defining the level of duty required that problems arise.

Someone who is deemed negligent in meeting the fiduciary standard may become legally liable for any damages incurred by the client. Negligence in financial dealings may take the form of the fiduciary acting in his (throughout this document the masculine form will be used, but the feminine form is to be understood) own best interests rather than those of the client, or it may result from supplying materially inaccurate or incomplete information to a client if proper care was not taken to substantiate it.

In addition to the advisor’s responsibility to know the investments they are recommending they must also know their client’s risk tolerance and capacity levels and financial situation. Any attempt to improperly increase a client’s risk tolerance level in order to market higher fee products must be scrupulously avoided, as must ‘churning’, the excessive and unnecessary trading of stocks in order to obtain higher commissions from a client's account, and ‘front running’ which involves purchasing a security ahead of the client in order to get a better price.

A fiduciary must always act on behalf of the client rather than himself. Thus, as an example, if an investment advisor promotes a mutual fund with a high commission over one with a lower commission solely to obtain greater compensation without any consideration given to the merits of the investment fiduciary duty has been breached. Or, if the investment advisor has a conflict of interest between his employer (e.g., a bank-owned brokerage from whom his remuneration is derived and to whom part of his sales commissions are passed on) and his client, the client must come first. Consequently, if the advisor is instructed by his employer to recommend a recent issuance of the brokerage, this can only be done if the product is suitable for a given client.

Many Canadian investors believe that their investment advisor already has a legal duty to put their clients' interest ahead of their own, yet the courts have decided that the current securities legislation that imposes a duty on advisors to deal fairly, honestly, and in good faith with their clients generally falls short of a legal fiduciary duty.

Adopting a universal fiduciary duty standard may disadvantage retail customers if such a requirement is imposed. Difficulties may arise as a result of increased prices passed on to the client as a result of, inter alia, compliance costs, malpractice liability insurance, lower returns to the advisor from reduced sales of more expensive products, the cost of eliminating or disclosing conflicts of interest, and additional costs required to investigate information sources. It has been argued that these increased costs may make those services too expensive for many lower or middle income clients. Alternatively, increased costs may drive some advisors from their profession, regardless of the quality of their services.

Imposing a fiduciary standard regulation is not unprecedented. Lawmakers in Britain, the U.S., and Australia have recently introduced legislation to strengthen investors' legal rights and raise the professional bar for investment advisors. One would think that Canada, rather than lagging behind, could play a leadership role in these activities. Perhaps it is because we have as yet not been able to even establish a Canada-wide agency to regulate securities transactions that we trail other developed countries.

Thus, one solution to the current demand for improvement in Canada's security regulations would be to impose a fiduciary duty on all investment advisors. It has the advantages of being in step with what is occurring in other jurisdictions, of providing a higher level of protection for individual investors than currently exists, and rendering more severe penalties to those who transgress. However, it is likely these improvements would come at a cost that would be borne ultimately by investors.

On the other hand, there is a large and vocal body of not only advisors but also some investors who claim that the current level of regulation would be satisfactory if it were administered uniformly and enforced more rigourously. This group points to the anemic record of successful prosecutions and the light sentences meted out in the past as evidence the present system has not been given a chance to work effectively. According to these individuals a tightening of the rules, better enforcement, and a better quality of judges or arbitrators would go a long way in fixing the system and promoting confidence for individual investors.

We submit that a combination of these two disparate approaches would be the best solution at this time. Certainly, a better enforcement of the current regulations would be helpful, and providing learned adjudicators would be an improvement. However, is it really sensible to leave order takers and advice givers in the same regulatory pigeonhole? We envision a two-tiered system containing an upper echelon of advice givers, as defined by training and experience, who would be classified as 'investment advisors' and considered under a fiduciary duty rule depending upon who they took on as clients, and a lower tier, who would be classified as 'dealer representatives', and would not be allowed to advise clients with whom a fiduciary duty is required. In other words, if an advisor is prepared and qualified to give substantial investment advice to a client he must also be willing to assume the onus of fiduciary duty if it is needed. These two tiers must be sharply delineated. The current practice of allowing misleading titles needs to cease.

The process would be a simple one. An additional few lines on the 'Know Your Client' form would indicate that the advisor and the potential client had discussed the relevance of fiduciary duty with respect to their proposed relationship, and that the potential client had been given printed information explaining the nature of financial fiduciary duty and had read it. The agreement reached as to whether fiduciary duty would apply or not would be indicated and signed by both parties. This agreement would be open to renegotiation at any time by either party. The question of what additional compensation the advisor might receive for the extra duties involved in performing fiduciary duties would be resolved by negotiation between the parties, entered on the form, and signed. Part of these fees may be assigned to the company to defray any extra costs they might incur.

The company's compliance officer would review this form, and if it was found to be in accordance with the existing regulations, it would be stamped and copies provided as necessary. This form would have to be provided by the company if a legal question as to the diligence of the fiduciary was raised. This step should save a great deal of time if any enforcement action was undertaken.

It is possible to envisage many cases where the fiduciary duty standard might be warranted, such, as inter alia:

A). A potential client that has very little knowledge or experience in investing and no desire to acquire any.

B). A potential client that will be at a distance from the advisor for a considerable period of time due to military service, company-based or recreational travel, etc.
C). A potential client that is or soon will be mentally or physically unable to make his own financial decisions.
D) A potential client that may be able and qualified to make his own financial decisions but has no interest in doing so.
Adoption of this proposal would, it is hoped, have the salutary effect of allowing the diverse group of stakeholders to reach agreement and move the enactment stage forward swiftly. It would also simplify enforcement actions. That would be an advantage to all those concerned with providing a uniform and equitable process for regulating investment advisors in Canada as well as to advisors and their clients.

V. SUMMARY OF RECOMMENDATIONS

We recommend that a two-tiered system be introduced in which an upper echelon of advice givers or 'investment advisors' would have a fiduciary duty to those clients requiring it, and a lower tier or 'dealer representatives' who would not be allowed to advise clients with whom a fiduciary duty is required. The presence or absence of a fiduciary duty would be agreed to jointly and in writing by the investment advisor and potential client at the outset of their relationship. This would be done using a modified 'Know Your Client' form. The agreement could be changed at any time by consent of both parties. Any regulations arising from this white paper must contain objective metrics to test the adherence of the company and the advisor to these new procedures.

VI. APPENDIX

Two examples will be provided of improper investment advisor-client relationships will be given through excerpts from my columns in the Canadian MoneySaver. Obviously, there are a multitude of such known abuse cases; I have selected these two because I have interviewed both individuals extensively and I am completely satisfied as to their validity.

Example 1. 'Are You Being Churned? Anne's Story' from the Canadian MoneySaver, 1998

"'Anne' has agreed to share her experiences with fellow MoneySaver readers. My goal with this article is to provide a well-documented case of the practice of 'churning' in hopes that it will serve as a warning to other investors and perhaps save some readers the same painful experience.

Anne is a highly educated 36 yr.-old woman who works in advertising for a major Canadian corporation. A few years ago she received several hundred thousand dollars from her parents as a result of her family's business and, not being a total novice with respect to investing, decided to put this money to work. Initially, she was faced with the same problem we have all had – how to select a broker. In this case she took the advice of a close friend and put herself in the hands of a Vice-President and Director of one of Canada's largest investment houses. As you or I would be required to do, Anne completed a 'Know Your Client' form. This form is mandatory for all new clients and elicits information about the individual's prior investment knowledge and current objectives. Here are Anne's pertinent answers:

'Account Objectives' Short term-34%, Inter. term-33%, Long term-33%

'Risk Factors' Low risk-70%, Medium risk-20%, High risk-10%

'Investment Knowledge' Good (Other choices-Excellent, Fair, Novice)

'Past Experience' Stocks, Mutual Funds, Bonds, Options

'Type of Option Approval Requested' Covered writing, Buying, Spreading, Naked writing

I should note that after some months Anne was contacted by the company and advised to alter her 'Risk Factors' as follows: Low risk-50%, Medium risk-30%, High risk-20%. She did this and signed another 'Know Your Client' form.

Now let's take a look at what was going on in Anne's account during this period. As you may have anticipated, her account was constantly 'churned', which means excess buying and selling done to benefit the broker. Also, although the broker described these strategies as high reward and low risk, the majority of the trades (80-90%) were in 'spreads' and 'straddles', options that require the purchase and sale of options of the same stock. The commissions on options is roughly twice that for common stocks and using these techniques means four trades – buying and selling the put, buying and selling the call – and four high commissions. Do you think anyone who requests 70% of her investments be in low risk vehicles should have used this strategy? In any case, how did she do? Again, as you may have anticipated, this column would not have been written if Anne had beat the market. Alas, such was not the case (Table 1).

Table 1. Returns of the major averages vs. Anne's 'spread' and 'straddle' options strategy.

Date	Anne	Dow Jones 30	S&P 500	TSE 300
5/31/95		4465	533	4449
11/30/97		7823	955	6513
Return (%)	+26	+75	+79	+46

So, not only did Anne's returns trail the major averages, she unwittingly made a major contribution to her broker; during this period her commissions totaled an ear-ringing $67,972, which was more than she gained from his advice!

Was Anne a hapless dupe in all this? Not really – she gave her approval for options, received monthly statements and was phoned prior to trades. Could it have been much worse? You bet – Anne was repeatedly encouraged by her broker to open a margin account, which she resisted. This story does not have a very happy ending since after more than 18 months of increasing concern she notified the broker not to make any further transactions in her account and wrote a letter to the president of the company. What followed was the usual litany of correspondence back and forth between Anne and the company's compliance department, resulting in no satisfaction. Currently, this matter is in front of the Investment Dealers Association of Canada, although Anne is becoming resigned to having learned an expensive lesson."

It is my opinion that whether fiduciary duty is applicable in this case or not, Anne was the victim of an unscrupulous investment advisor. Yes, Anne must share a part of the blame, but she certainly didn't deserve the viscous and premeditated treatment she received from an advisor much more interested in what the investment products paid him than what they paid his client. As far as I know she never was reimbursed for any of her losses, nor was the investment advisor censured since, of course, his employer backed him up in his denial of responsibility.

Example 2. 'The Heroic Saga of Mrs. B. — A ShareClub Empowerment Story' from the Canadian MoneySaver, 2010

"This column attempts to chronicle the transformation of 'Mrs. B', the pseudonym of a real person who first visited our ShareClub in 2005. She has agreed to let me try to tell her story and I thank her for allowing me to bring it to you. Mrs. B. had recently retired from the teaching profession and, like the vast majority of us, had never received any formal instruction in finance or investing. Now she found herself in a situation where she had a sizeable nest egg sitting in mutual funds and GICs, and what she perceived as a dubious financial advisor strongly urging her to sink more of her savings into poorly performing mutual funds with fat trailer fees.

This advisor baffled and bullied her with financial double talk when she suggested buying and holding blue-chip stocks. She was torn between loyalty to the advisor, with whom she had dealings over a decade and who had been recommended to her by a family friend, and some of the concepts she was beginning to glean from her reading of the Canadian MoneySaver. Exacerbating all this was an elderly parent who had suffered a debilitating stroke and needed the care provided in a nursing facility. This meant selling the family home and dealing with the resultant proceeds.

At her first ShareClub meeting Mrs. B. quite openly related the situation in which she found herself. As you might imagine the advice she received was blunt and to the point: “You are being systematically robbed; find a new advisor; dump the mutual funds; educate yourself; build a portfolio of stocks, ETFs, and bonds; etc.” Well, life isn’t that easy is it? The real story is how Mrs. B. got from that point to where she is now.

The learning tools Mrs. B. employed included taking two courses in investing at a local college, a wide-ranging reading program, and real-life experience…The previous advisor was jettisoned in favour of someone with better listening skills and a willingness to assist in selling some mutual funds, but he still persisted in adding more mutual funds under the guise of 'diversification'.

Now she has only two mutual funds left and before her last meeting with her third advisor she called the company directly to find out exactly how much it would cost to divest herself of these remnants. When the TFSA program came into being she took the giant step of setting up her own fee-free account on-line and investing all on her own…Mrs. B. currently favours safe Canadian blue-chip stocks with meaningful dividends that she can reinvest."

Could Mrs. B ever have hoped to recoup any of her losses that resulted from being 'baffled and bullied' by an investment advisor? Not a chance. But here is just one more case of a hapless retiree being coerced into purchasing investment products that were not suitable and designed more for the advisor's benefit than for the client. What are the odds that a given investor will strike it lucky and get an advisor that actually counsels a sensible investment strategy? Who knows? Apparently those data are unavailable.

These two examples only underline the fact that investment advisors providing bad advice and using unethical practices to generate inflated commissions for themselves represent the greatest potential financial risks for individual investors. If the recommendations advocated in this submission were in effect when the examples given here happened it is likely different outcomes would have resulted. Timely implementation and strict enforcement of current and new investment regulations are the best ways to address the problems facing Canadian individual investors.

David W. Stanley
P. O. Box 12
Rockwood, ON
N0B 2K0
davids5209@aol.com