Federation of Mutual Fund Dealers

February 22nd 2013

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

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

The Secretary
Ontario Securities Commission
20 Queen Street West, Suite 1903, 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 / Mesdames:

RE: Canadian Securities Administrators Consultation Paper 33-403: *The Standard of Conduct for Advisors and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients*

The Federation of Mutual Fund Dealers (the "Federation") is an association of Canadian mutual fund dealers and affiliates whose members, since 1996, have been working to be the voice of independent mutual fund dealers. We currently represent dealer firms with over

$114 billion of assets under administration and 17,000 licensed advisors that provide financial services to over 3.5 million Canadians and their families. A list of our members can be found at www.fmfd.ca.

The Federation is writing to provide comments with respect to the above captioned Consultation Paper (the “Paper”).

We are providing comments on specific issues identified by our membership first, and then we will continue with items where we have comment, in the order and under the headings as presented in the Paper. With respect to the Paper’s *Consultation Questions*, we believe these questions premature as there is, as of yet, no consensus on the imposition of a best interest standard.

General

The Paper discusses a standard, then suggests carve-outs to that standard; discusses conflicts and remuneration, but does not discuss the legal ramifications of the imposition of a fiduciary standard – what happens in court with/without a fiduciary standard. What is the impact on the client who is completely innocent; what is the impact on the client who is culpable; and what happens to the advisor given those two examples? We believe this to be a significant omission and should be included in any future consultation papers on this subject.

There is no attempt in the CSA Paper to define "best interests". The term is more commonly used in relationship between a medical professional, caregiver or substitute decision maker and an individual who is incompetent or unable to ascertain his/her own interests with respect to medical care or withdrawal from medical care. Since many of these best interest decisions are made in life or death circumstances, e.g. withdrawal from life support, there is no objective way to discern whether such decisions were in fact, in the individual's "best interests". All we might be able to discern is whether the judgment of the substitute decision maker was made to the best of their ability with as much information as could be reasonably be made available in the time frame available, and made with compassion and where all evidence would indicate that the decision reflected the values of the individual within reason.

We would argue that "best interests" in the financial advice industry is not ascertainable in any reliable way, that the use of the term is misleading to the public and should be abandoned by regulators in their attempt to advance the public interest and will create an untenable amount of liability for anyone entering into a relationship defined in these terms.

The Paper implies that ‘best interests’ and ‘fiduciary’ are compatible, and yet the Paper makes clear that "a fiduciary duty does not require the fiduciary to act as "guarantor" or "insurer" with respect to his or her advice.” Put another way, advisors are "…under no duty to offer only successful financial advice" they "will inevitably make wrong predictions and it is difficult, in hindsight, to question honest investment advice." In the footnotes, Australia makes it clear "the focus of the duty should be on how a person has acted in providing advice rather than the outcome of that action." This is precisely the point of departure between best interests, which necessarily can only be determined after the fact, in hindsight, and the fiduciary duty. If you cannot define it, then how do you supervise and/or enforce it?

A clear definition of 'best interests' and the proposed 'fiduciary standard' in context are absolutely essential so that the industry understands what the differences are on the practical side as well as the settlement side i.e. fiduciary differences on product-selling/selecting versus advice-providing activities.

We would also ask - can you have a pure fiduciary relationship that isn't discretionary?

Over-regulation

We are concerned about the over-regulation of the securities industry in Canada and in particular the over regulation of the mutual fund channel of distribution. From the introduction of the Mutual Fund Dealers Association, an SRO not founded by the industry for the industry but by enforcement regulators who pursued an enforcement regime of regulating mutual fund dealers and their advisors, to other impactful events such as the changes to business indicated by NI 31-103, CRM, and the proposed cost and performance requirement measures, layer upon layer of requirements have been placed on this channel with no assessment of duplication or concern for the detrimental effects this has had on manufacturers, distributors, advisors or the investing public.

We absolutely agree that protection of the investing public is paramount; however, if, as an unintended consequence, the investing public is harmed then the regulatory regime is counterproductive.

We would strongly encourage the CSA, before it considers introducing any new policies, especially any which might affect this channel of distribution, to analyze all applicable Rules, Policies, Acts, etc., that apply and remove redundant, dated and unnecessary regulations. We are not alone in this sentiment and would draw your attention to the remarks of Thomas Caldwell, Chairman of Caldwell Securities on January 3rd 2013 at an address to the Empire Club Investment Outlook Luncheon, attached for your information.

We find that the broad brush of investor protection lacks any specific objectives against which each new proposed regulation can be measured in terms of its effectiveness in creating the change or obtaining the intended objective. With so many rules being proposed and imposed towards the broad objective of investor protection, and with the lack of time given to measure the impact of one regulation before another is imposed we contend that the CSA will never be in a position to determine the impact or success of any new regulation. Further, how can rules be tweaked or unintended consequences be corrected when we simply will not be in a position to point to the change or isolate the regulation that created them in the first place?

Regulatory Arbitrage

It is essential that the impact of proposed policies across all channels of distribution be assessed to ensure that the imposition of the policy does not disadvantage one channel over another which could lead to, among other things, further regulatory arbitrage. We say 'further' because it exists today where advisors move assets from the mutual fund channel to insurance (segregated funds) in order to avoid the overly onerous compliance regime in favour of one with little or no regulation, higher remuneration, and less cost to run their business.

Segregated fund fees to clients were historically higher than mutual funds, however several segregated fund manufacturers have now synchronized their fees with mutual funds so as to avoid some related suitability challenges. In addition, there are substantial benefits that can be provided to segregated fund advisors by insurance companies which are prohibited in the mutual fund distribution channel. We believe this move to segregated funds to be a demonstrable existing and future consequence and not in the best interests of the investing public.

In most jurisdictions where the securities regulator has rule making authority, the regulator, in order to solve this issue, may remove the exemption for segregated funds thereby including segregated funds in the definition of 'securities' which would stymie the above consequence.

Cost Benefit Analysis & Costs

We note in the Paper that other jurisdictions mentioned, Australia, the U.S., England and the EU for example have, to one degree or another, conducted a cost benefit analysis and, in fact, that the FSA intends to conduct a further cost benefit analysis one year after their rule and policy changes come into effect in order to assess impact.

"The SEC Study also included some detailed yet preliminary cost-benefit analysis". This study cited "a lack of (i) evidence of investor harm caused by the current regulatory regime, and (ii) reasonable cost benefit analysis of imposing the proposed standard." We also note that the SEC "has been significantly delayed in releasing a rule because of its attempts to conduct a robust cost-benefit analysis at this stage. As part of this process, the SEC is planning to ask investment advisors and others to provide data about the costs and benefits of the recommended best interest standard. It is unclear at this time when the SEC will move forward on this initiative."

Contrary to the Paper's contention that the CSA "is mindful that potential cost increases for such advisors and dealers may occur" we do not believe that the CSA is prepared to accept the real, and significant costs to the industry and ultimately to the client. This is evidenced by the Paper's contention that "Although a precise cost-benefit analysis is not feasible at this stage…" The CSA has yet to provide a cost benefit analysis to any proposed policy in spite of the statutory requirement to do so.

We would argue that the CSA could avoid The SEC's misstep and demonstrate first - where the harm is/what is broken currently, and second - as we have requested in other submissions to the CSA, conduct your own cost benefit analysis based on the Canadian market experience and would remind you of the statutory obligation to provide such an analysis with proposed policies. At recent industry events, and in particular the Ontario Securities Commissions' ("OSCs") 'Dialogue' October 30th 2012[1] representatives from the Ontario Securities Commission (the "OSC") commented that while some cost information has been made available to them, to assess the benefits is almost impossible so they don't intend to pursue that. We would argue that if it is possible for other jurisdictions to conduct such an analysis, their Canadian counterparts should be able to also.

These same panelists stated that costs may increase although they do not articulate why, and go on to state that these increased costs should not be passed along to clients. We believe this to be a very naïve concept. In reality, the cost of a security, as with the cost to bring any other manufactured product to market that a consumer may purchase, is borne entirely by the consumer. And increased costs will not be a one-time occurrence.

- Technology costs will increase as dealers build out their systems so that they will be able to provide clients with a comparative analysis of products which will be required in order to prove the suitability of the products recommended or sold.
- Technology upgrades will come with a cost and the advisors will be assessed a monthly fee in order to access these applications directly.
- Overhead will increase as staffing focused on technology grows.
- Errors and Omissions insurance costs will increase as suitability requirements become more onerous than they already are and the ability to mitigate losses and negotiate settlements are affected.
- Legal costs will increase

[1] **Investor Issues Panel** Panelists will discuss the role of disclosure and regulatory intervention in investor protection, with a focus on current investor initiatives relating to fiduciary duty, the client relationship model, mutual fund fees and dispute resolution. **Moderator:** Mary Condon, Vice-Chair, OSC; **Panel:** Tom Bradley, president, Steadyhand Investment Funds Inc., Eleanor Farrell, Director, Office of the Investor, OSC, Rhonda Goldberg, Director, Investment Funds Branch, OSC, Chris Jepson, Senior Legal Counsel, Compliance & Registrant Regulation Branch, OSC, Jeff Scanlon, Legal Counsel, Compliance & Registrant Regulation Branch, OSC

- The ability to recruit into this channel of distribution will be detrimentally affected; with personal liability comes unwillingness on the part of individuals to participate, especially when they see court cases involving acknowledged sophisticated investors who have a history of suing advisors, winning in court.

The Small Investor

As the cost to bring any product to market rises the inevitable occurs - the product is priced beyond what some consumers may be able to afford or want to pay for. This is a real concern for us and should be for the CSA if investor protection is at the heart of what we do. The small and arguably unsophisticated and perhaps financially illiterate investor will not be able to afford the fees associated with investing and advisors will not be able to service accounts under a certain amount. This watermark will vary from firm to firm however, it will be there. This particular 'unintended consequence' should not be acceptable to anyone.

And we would agree with the "SIFMA Study, retail investors would experience "reduced product and service availability and higher costs" under a uniform standard of care for investment advisors and broker-dealers "that does not appropriately recognize the important distinctions among business models.""[2]

- end of general comments –

1) <u>Introduction</u>

According to the Paper, the impetus appears to be "the 2008 global financial crisis and its aftermath [which] have generated significant debate on the standard of conduct that advisors and dealers owe to their clients when they provide advice on investing in financial products." While we appreciate that global events should be monitored with a view to assessing the impact on our own country, we would like to ask – "what is broken in Canada?" Is there evidence enough here that the conduct of Canadian advisors, and mutual fund advisors specifically, is deficient and a clear and present threat to the investing public exists without the imposition of this proposed standard?

- FPSC Code states: "A CFP who takes custody of all or any part of a client's assets for investment purposes, shall do so with the care required of a fiduciary."
- MFDA Rule 2 Business Conduct states that each registrant will "deal fairly, honestly and in good faith with its clients; observe high standards of ethics and conduct in the transaction of business; not engage in any business conduct or practice which is unbecoming or detrimental to the public interest".
- Ontario Securities Act: it was and still is a requirement of the OSA that all securities related business be processed through and/or approved by the mutual fund dealer. It is also expected that regardless of the business contemplated, any registrant, regardless of the category of registration will act in the best interests of the client, any client.

[2] CSA Consultation Paper 33-403 pg. 25

- The IFIC Code of Best Practices says “To make suggestions for change in a personal financial program only in the best overall interests of the client.”

2) Background

The Paper says “The principal question is whether advisors and dealers should have an obligation to act in the best interests of their clients when providing advice to them.” We would argue that based on the above information, this standard already exists. Do clients understand this? Some may and some may not, but you cannot account for a client’s unwillingness or inability to comprehend that concept fully and imposing a fiduciary standard would not, in and of itself, solve any problems – in fact if the client is at all culpable it would remove the opportunity for the client and advisor to participate in an equitable settlement.

3) Fiduciary Duty: What it is and when it arises at common law

We believe that existing securities regulations currently adequately ensure that:

- client interests are paramount
- conflicts of interest are avoided
- clients are not exploited
- clients are provided with full disclosure, and
- services are performed reasonably prudently

We agree that “a fiduciary duty does not require the fiduciary to act as “guarantor” or “insurer” in respect of his or her advice…”under no duty to offer only successful financial advice”; they “will inevitably make wrong predictions and it is difficult, in hindsight, to question honest investment advice.”

Laura Paglia, Torys, is quoted at page 10 in the Paper saying “the core principles being debated in the U.S., which revolve around disclosure of conflicts of interest and putting the client’s interest first, were already generally accepted in Canada under the duty of care owed by all financial advisors to their clients”; and Philip Anisman is quoted as saying “although our courts have not yet recognized that it does so, this rule arguable imposes a fiduciary obligation on…registrants with respect to their clients: He recommends that “our regulators may be better advised to … enforce [the duty to deal fairly, honestly and in good faith with the clients] rigorously.”

Quebec’s civil code says “He shall also act honestly and faithfully in the best interests of the mandatory, and avoid placing himself in a position that puts his own interest in conflict with that of his mandatory”. “It is worth noting that according to the authors…this obligation to act with loyalty (or faithfully) is comparable to that of the common law fiduciary standard…”

It is important to note that the concept of “discretion” is not applicable to mutual fund dealers. Additionally, regardless of how often a mutual fund representative deals with the client, fulsome and current (within 12 months) 'know your client' ("KYC") information is always required; that the Mutual Fund Dealers Association expects one KYC for each account, and that there be separate accounts for each 'type' of registration e.g. LIRA, RRSP, Open, etc., not one KYC for the "client's whole range of accounts".

If there is a concern that products offering higher compensation would attract advisors to sell those products over other 'like' products with a lower compensation structure, we would suggest that the industry consider leveling the playing field for 'like' products.

At page 18 the Paper states that "suitability determinations will not be required if the account is an order execution-only account." We would like to suggest that mutual fund dealers and their advisors be allowed the same condition in order to not continue to over-burden this channel of distribution.

Given the strict regulatory requirements placed on mutual fund dealers and their advisors regarding the expectation they act in the client's best interests, and the application of this expectation can be seen in many MFDA hearing results, we were disappointed to see "The IIROC rule requires only that the Dealer Member "consider" the best interests of the client". While the MFDA's rules on conflicts of interest may be similar to IIROC's, it is clear that the expectation is greater, and greater at the OSC as well if their position on outside business activities is any example.

At any point where the term "reasonable" is used it leaves room for interpretation which is inherently problematic, for clients, advisors, dealers and regulators. The Australian Reforms suggest that ""reasonable investigation" does not require an investigation into every financial product available; however, it would include any specific financial products that the client requests the advice provider to consider in [their] analysis". This is fraught with problems as we are sure the CSA would agree and we would ask that you not adopt any language so open to interpretation.

Concern 1: Principled Foundation

The Paper states that "advice for investing in securities is arguably *not* just like any other business transaction or interaction" referring to the principles of "buyer beware". We would argue that they are not mutually exclusive, "buyer beware" must be incorporated into any and all 'suitability' considerations which would be negated should a strict fiduciary duty standard be applied. We would also argue that if clients were educated as to their responsibility in the relationship, they would be more engaged and would be more open to education.

Concern 2: Information and financial literacy asymmetry

As stated above, if clients were more aware of the inherent responsibility they bear for their investments, they would, perhaps, be more willing to be educated in the investment process.

We would contend that today, they are quite happy to waive their own responsibilities in favour of any advice they are given, and are therefore quite happy to place all of the responsibility on their advisor. This is neither a tenable or responsible position.

The investment community, like any other educated community, does not expect its clients to be as educated as the professionals that it clients turns to, however, the investment community does expect the client to take responsibility for the ultimate decisions it makes, especially within the mutual fund dealer community where, as stated above, discretionary trading does not take place.

Concern 3: Standard of conduct expectation gap

We do have concerns that the Investor Education Fund considers that “extensive research” amounts to the study of 2000 Canadians. The current population of Canada is 34.5 million and we would therefore suggest that the results of the research be considered in this context.

This section also states that “These findings are of concern because, as discussed above, advisors and dealers are not always legally required to act in their clients’ best interests.” However, as we have stated above, the regulatory requirements are quite clear in requiring that mutual fund registrants act in their clients’ best interests.

Concern 5: The application in practice of the current conflicts of interest rules might be less effective than intended

We agree with the Canadian securities regulators intent “to ensure that clients receive meaningful disclosure about conflicts of interest without imposing unnecessary regulatory burdens on registrants”; we believe this is a sound policy. At the same time we refer you to our suggestions above with respect to removing redundant, dated and unnecessary regulations. It would be unrealistic to believe that those advisors and the dealers who facilitate their registration work for no remuneration. In theory, commissions are paid for the work that advisors do for clients prior to and up to the purchase a security and dealers keep a portion for the provision of their services to their advisors. Trailer fees are paid for the on-going services that advisors and therefore dealers are required – by obligation **and regulation -** to provide to those same clients.

Take for example a client who opens a modest account with an advisor, one account, one investment of $25,000.00 placed in a mutual fund and held for 10 years where the client’s circumstances do not change over that time period. Regardless, the advisor is required on an ongoing basis to monitor the suitability of the client’s investments, and annually, at a minimum, to connect with the client to ensure that their original KYC information is current and the dealer is required to deliver to the client quarterly statements, disclosures, etc. Over that ten year period, only the trailer fees pays for that on-going regulatory obligation of the advisor and dealer. If the client requires servicing which does not result in the injection of ‘new’ money into their account, that too is 'paid' for via trailer fees. Being paid for the time an advisor spends with a client is not, inherently, a conflict. However, the discussion of conflicts visa vie commissions and trailer fees is moving the industry towards a fee-based business model. This move will, again as noted above, will disadvantage the smaller client.

7) Consultation on the Appropriateness of Introducing a Statutory best interest duty when advice is provided to retail clients

We do not understand why the best interest standard would not be applied to exempt market dealers and scholarship plan dealers. As noted above, 'best interests' is either a sound policy for the investing public generally, or it is not. It should therefore be applied uniformly, or not. In support of this see a recent Investment Executive article entitled "Scholarship Plan Facing OSC Hearing".[3] We would also suggest that under the *General Scope* section (v) should read "except as in (ii) above".

Regards,

Sandra L. Kegie
Executive Director

Attach.

[3] This article may be found at http://www.investmentexecutive.com/-/scholarship-plan-facing-osc-hearing?utm_source=newsletter&utm_medium=nl&utm_content=investmentexecutive&utm_campaign=INT-EN-All-afternoon