Comments on Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients

Regarding Canadian Securities Administrators' Consultation Paper 33-404

CONSUMERS COUNCIL OF CANADA

© Consumers Council of Canada, 2016

Version: 16-10-19 9:47:56 AM

Consumers Council of Canada

Commercial Building
201-1920 Yonge Street
Toronto, Ontario M4S 3E2
Canada

http://www.consumerscouncil.com

Table of Contents

Comments on Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients i

Table of Contents iv

The Consumers Council of Canada's Comments 1

Synopsis 1

Council principles 2

Market assessment – The failure of the product suitability approach to investor protection 4

Fundamental concepts of protection 6

A 'best interest' approach to investor protection 9

Benefits of a best interest standard in addressing specific harms 11

Conflict of interest 11

Misleading marketing practices and use of titles 11

Key processes used to serve investors – risk profiling 12

Accessible, fair and affordable redress and restitution 12

The Voice of the Investor 13

Appendices 1

Appendix I - Investment Adviser Expertise 2

Appendix II – The Incremental Nature of the Best Interest Standard 3

Appendix III – The BCSC Objections 4

Appendix IV – The Conflict of Interest Between Investment Advisers and Clients 9

Appendix V – KYC and Suitability 10

Appendix VI – The Necessity of Effective Legal Redress 11

OBSI is not a satisfactory alternative means of legal redress 12

The Consumers Council of Canada's Comments

Over the years, evidence accumulated that demonstrates the suitability standard has failed to meet the regulatory purpose of investor protection.

The Consumers Council of Canada, a non-profit, voluntary organization, works towards an improved marketplace for consumers in Canada. The Council appreciates the opportunity to speak on behalf of retail consumers of investments and investment services, to provide comments on the Canadian Securities Administrator's consultation paper 33-404 "Proposals to Enhance the Obligations of Advisers, Dealers, and Representatives Toward Their Clients" published April 28 2016.

Synopsis

- The Council recommends the financial consumer protections found in High-Level Principles on Financial Consumer Protection endorsed by the G20 Finance Ministers and Central Bank Governors in 2011.
- The Council agrees that the CSA's proposed framework for a regulatory 'best interest" standard is consistent with the fundamental principles of integrity in the capital markets and investor protection which underlie Canadian securities legislation.
- It is time for Canadian securities regulators to stop blaming the investor. The product-centric suitability approach to protection, which relies on disclosure "working", ignores fundamental truths and societal norms. It not only harms investors, it has created a regime within which investors will be deliberately and intentionally harmed.
- A 'best interest' approach to investor protection is investor-centric and aligns with regulatory goals and purpose. A best interest standard treats investor interests – individually and as a collective – as paramount. It protects against those who are self-regulated engaging in practices that are self-serving.
- The Council is in the company of other investor-protection oriented organizations calling for better retail investor protection.
- A regulatory approach which puts the retail investor interests as paramount would necessarily have provided a system of accessible, fair and affordable redress and restitution many years ago. Now is the time to get that done.

Council principles

The Council seeks an efficient, equitable, effective and safe marketplace in which consumers are able to exercise their rights and responsibilities.

The Council subscribes to the Charter of International Consumer Rights, adopted and developed over 50 years ago as part of the international consumer movement, which rights include the right to sufficient accurate information to make an informed choice in a consumer transaction and the right to satisfactory redress in case of a consumer injustice.

Specifically, the Council advocates for:

- The right to safety.
- The right to choose.
- The right to be heard.
- The right to be informed.
- The right to consumer education.
- The right to consumer redress.
- The right to a healthy environment.
- The right to basic needs.
- The right to privacy.

The Consumers Council of Canada is committed to:

A Voice for Consumers: We endeavor to be a voice for consumers across Canada.

Listening to Consumers: We work to listen to consumers and develop policy consistent with what we are told.

Consumer Empowerment: We provide leadership in educating and informing consumers about their rights and responsibilities.

Stakeholder Involvement: We actively seek the advice of a broad range of stakeholders, including other consumer groups, and assess the specific suggestions made, to incorporate, where appropriate, their advice into the Council's policies and programs.

The Council recommends the financial consumer protections found in *High-Level Principles on Financial Consumer Protection* endorsed by the G20 Finance Ministers and Central Bank Governors in 2011. To summarize:

1. Financial consumer protection should be an integral part of the legal, regulatory and supervisory framework.
2. There should be oversight bodies explicitly responsible for financial consumer protection, with the necessary authority to fulfill their mandates.
3. *All financial consumers should be treated equitably, honestly and fairly at all stages of their relationship with financial service providers.*[1]
4. Financial services providers and authorized agents should provide consumers with key information that informs the consumer of the fundamental benefits, risks and terms of the product.
5. All relevant stakeholders should promote financial education and awareness, and clear information on consumer protection, rights and responsibilities should be easily accessible by consumers.
6. *Financial services providers and authorized agents should have as an objective, to work in the best interest of their customers and be responsible for upholding financial consumer protection. Financial services providers should also be responsible and accountable for the actions of their authorized agents.*[2]
7. Relevant information, control and protection mechanisms should appropriately and with a high degree of certainty protect consumers' deposits, savings, and other similar financial assets, including against fraud, misappropriation or other misuses.
8. Consumers' financial and personal information should be protected through appropriate control and protection mechanisms.
9. *Jurisdictions should ensure that consumers have access to adequate complaints handling and redress mechanisms that are accessible, affordable, independent, fair, accountable, timely and efficient.*[3]
10. Nationally and internationally competitive markets should be promoted in order to provide consumers with greater choice amongst financial services and create competitive pressure on providers to offer competitive products, enhance innovation and maintain high service quality.

---

[1] Emphasis added
[2] Emphasis added
[3] Emphasis added

Market assessment – The failure of the product suitability approach to investor protection

For many years, retail investors have been harmed by the unintended consequences of a flawed regulatory framework that was adopted at a time when the markets and products were, in retrospect, simple and stable. Markets were dominated by institutional participants and advisers directly representing affluent clients. However, this changed with increasingly ‘democratized’ access to investing, leading to a dazzling array of new, and then increasingly challenging-to-understand products. Guiding retail investors through investment choices became a rapidly mounting problem. Even as the fundamental flaw in the regulatory approach became more apparent over the years, the securities industry became more resistant to reform. But the time for change has come.

The Council agrees that the CSA’s proposed framework for a regulatory ‘best interest” standard is consistent with the fundamental principles of integrity in the capital markets and investor protection which underlie Canadian securities legislation. This is an investor-centric mandate for securities regulators. The suitability standard which is currently in place, is product-centric; it is not investor-centric. History teaches us time and again when regulatory standards are not in alignment with regulatory or legislative purpose, regulatory goals are not met. And such is the case here.

Over the years, evidence has accumulated that demonstrates the suitability standard has failed to meet the regulatory purpose of investor protection.[4] [5]

- Under the suitability standard, billions of dollars have been taken from retail investors and ended up in the pockets of sales people, investment “advisers” and shareholders of industry participants.
- Under the suitability standard, the use of embedded commissions has mitigated protecting the investor and has resulted in bad advice and harm to investors.[6]
- Under the suitability standard, a plethora of misleading, confusing and at times near-fraudulent titles have been used to lure retail investors into a false sense of security where their trust was abused and they were harmed.[7] [8]

---

[4] Sparrow, Malcolm K. (2011), *The Regulatory Craft*, Brookings Institution Press, Washington, DC
[5] Sparrow, Malcolm K. (2008), *The Character of Harms: Operational Challenges in Control*, Cambridge University Press, Cambridge, England; New York, USA.
[6] CSA Staff Notice 81-327, *Next Steps in the CSA’s Examination of Mutual Fund Fees*
[7] Ontario Securities Commission (2015) *Mystery Shopping for Investment Advice: Insights into advisory practices and the investor experience in Ontario.*
[8] CBC MarketPlace (2015), “Mystery shoppers show financial advisers failing to fully inform clients” http://www.cbc.ca/news/business/financial-advisers-mystery-shoppers-1.3233952

- Under the suitability standard, KYC/risk profiling has failed to provide the intended result of protecting investors from investment purchases that harm the investor.[9] [10]
- Under the suitability standard, mutual funds sold to retail investors in Canada have the highest costs of mutual funds in any peer-group country, which has harmed the investor.[11]
- Under the suitability standard, basic product information has been withheld and efforts to provide that information to retail investors have taken more than a decade, leaving them in the dark in the meantime.
- Under the suitability standard, Ombudsman for Banking Services and Investments, a small retail investor's only unbiased and affordable place of recourse has broken down, resulting in harm to retail investors. The recent review of OBSI uncovered a playing field that is not level, but tilted against the small investor.[12]
- Under the suitability standard, too many times, seniors have been led inappropriately into investing with significant losses of savings, sense of well-being and dignity, and health[13] – most unfortunately suicide has been reported in some cases.

Under the product-centric suitability standard, the regulatory purpose of investor protection has not been used as the overarching lens by which all activity and business processes were viewed and evaluated prior to implementation. As a result, investors have been harmed. Let there be no mistake about this. Investors are living with the burden and harm resulting from the product-centric suitability approach to protection.

Our society has said retail investors deserve to be protected: the law has given the investor protection mandate to regulators. Investors deserve to have their interests treated as paramount and not see their financial capital – their savings, their means of living – used to serve the interests of others first. For decades, under the suitability standard, retail investors' savings have been used by industry participants to serve the interests of others first.

---

[9] Investor Advisory Panel, Ontario Securities Commission (2015), *Current Practices for Risk Profiling in Canada and Review of Global Best Practices*.
[10] Canadian Association of Retired Persons (2016) *Submission to the OSC on Priorities for Fiscal 2017,* http://www.carp.ca/wp-content/uploads/2016/06/16-05-09-CARP-Submission-to-Ontario-Securities-Comission.pdf
[11] Alpert, Benjamin N.; Rekenthaler, John, *Global Fund Investor Experience 2011*, Morningstar
[12] Battell, Deborah; Pender, Nikki (Independent evaluators) (2016), *Independent Evaluation of the Canadian Ombudsman for Banking Services and Investments' (OBSI) Investment Mandate*
[13] Canadian Association of Retired Persons (2016) *Submission to the OSC on Priorities for Fiscal 2017,* http://www.carp.ca/wp-content/uploads/2016/06/16-05-09-CARP-Submission-to-Ontario-Securities-Comission.pdf

The Council finds it unconscionable that the suitability standard explicitly permits the salesperson/adviser to place their own financial interests ahead of those of their customers in making recommendations on investment products and strategies. That is not protection. That is patently unfair.

It may seem obvious, but it is useful to remember that retail investors are not handing over money to buy a washing machine or a car, a product that will deliver functionality if not enjoyment. When investing, retail investors are handing over their savings, often their life savings.

It is retail investors who collectively provide trillions of dollars of financial capital that the industry uses to expand and earn profits. It is the retail investors' capital that makes it possible to pay the commissions and bonuses of many client-facing salespeople and advisers. It is their own personal financial capital that they have invested, have entrusted. They should not need to worry that their capital might be used to serve another person's best interest ahead of their own. And yet, under a suitability standard, worry they should. That is how it works under a product suitability approach to protection.[14]

The Council calls on all provincial regulators to reject the product-centric suitability approach to investor protection and adopt an approach that aligns with their regulatory purpose and goals – protecting the investor.

Fundamental concepts of protection

Retail investors, who are consumers of retirement investment products and advice, have been blamed time and again for their ignorance and stupidity, for being greedy, for being unrealistic. In an industry where regulatory thinking has been dominated by insiders and lawyers, the expectation of retail investors' capability has been unrealistic and often disrespectful.

A fundamental concept in consumer protection is this. An unfair practice is one that involves making an unconscionable representation. An unconscionable representation includes those situations where the person making the representation knows or ought to know that:

[14] "Reflecting their origins as salespeople, brokers are subject to a suitability standard. That standard requires them to make recommendations that are generally appropriate for their customers based on a detailed understanding of the customer's financial situation and needs, but allows them to place their own financial interests ahead of those of their customers in selecting the particular investment products and strategies to recommend." Testimony of Barbara Roper, Director of Investor Protection, Consumer Federation of America, Before The Capital Markets and Government Sponsored Entities Subcommittee Financial Services Committee, U.S. House of Representatives, September 13, 2011

- the consumer is not reasonably able to protect his or her interests because of ignorance, illiteracy or an inability to understand the product and the agreement into which they are entering;
- the consumer transaction is excessively one-sided in favour of someone other than the consumer;
- the terms of the consumer transaction are so adverse to the consumer as to be inequitable;
- a statement of opinion is misleading and the consumer is likely to rely on it to his or her detriment.

The concept of an unfair practice recognizes some fundamental concepts about what retail investor protection needs to be about.

- **The consumer is not and should not have to be an expert in order to protect her or his interests in a transaction.** It is absolutely unreasonable to expect all retail investors to have the wherewithal to understand the implications of investment products given the complexity of the markets and their unawareness of, and inexperience in interpreting all the risks and variations that are masked by simplified disclosure.

  Studies have indicated that financial literacy in Canada is deficient. However, that is the marketplace that the regulators must regulate within – the real world, not in some future state that does not exist.

  Even financially literate Canadians investors who are not of or in the industry, are challenged to understand and interpret the information they are given and then apply that to their own situation. It is unreasonable to expect that they be able to do so. They are the customer.

- **The consumer will rely on what s/he is told.** Our society expects and understands that consumers who are non-experts will rely on experts when making important decisions. Our society does not expect clients of lawyers to know the law; clients of real estate brokers to understand the marketplace to the extent their adviser does; patients of doctors to understand the human body and their particular ailment and options for treatment to the extent their doctor does. Why? Because our society understands and supports the reality that consumers will rely on experts, on what the expert tells them, should be able to rely on experts in important things, should not be blamed for or be harmed from lacking expertise and experience. And to the extent they do rely on those with more expertise, they need to be protected against self-serving practices of those experts who would take advantage of their in-expertise.

Whether the person professing to be the expert is trustworthy or not, competent or not, self-serving or not, the consumer will rely on the expert. This has been borne out time and again by research, including research done by the OSC. Knowing that investors rely on what the salesperson tells them, knowing that this is the real world situation that regulators are charged to address, it is unconscionable for securities regulators to keep a regime which essentially says “Investors can’t and shouldn’t trust sales people/advisers not to act in a self-serving way. Investors are too trusting.” Blame the investor. Appendix I to these comments elaborates the Council’s thoughts about investment adviser expertise.

Equally problematic is the “halo” effect, which can be used to create reliance. Witness the practice of large bank-related registrants who use their bank brand to create a halo of security and trust over their mutual fund sales departments and their dealer/wealth management business. How many retail investors understand that the protection afforded them as banking customers does not automatically flow to their other relationships within the banking group? How many even understand what it means to not be buying “from the bank”? Using the halo effect from sister-company regulated bodies compounds that problem for investors and increases the need to provide the same protection standard across all entities.

A consumer is at the mercy of what the sellers choose to tell them. Relying on the disclosure of investment product information to provide protection is necessarily a flawed strategy. Over the years securities regulators have relied extensively on “disclosure” and “education” to achieve the goal of investor protection. Events in the Canadian securities industry have provided additional evidence that over-reliance on a “disclosure” approach to protection does not work, and that the costs of the system failure have been and are being borne by retail investors.

In the early 1990s, the Ontario government’s Ministry of Consumer Services came to the realization that disclosure does not provide protection especially when the person doing the disclosure has a vested interest in making a sale. As a result in Ontario, the government replaced the consumer protection legislation for self-regulated industries with statutes, regulations and codes of conduct requiring a best interest standard. Other provinces have likewise adopted best interest standards for self-regulated industries. Notwithstanding all that is written down and presented to the investor, what the person across the table says to the investor is likely to hold more influence, even determine the outcome. This has been demonstrated time and again in research and in real life. That is what other regulators have recognized and addressed.

There is ample evidence in other countries to show investor protection regimes that rely upon disclosure and education do not result in protection. Financial services regulators in the UK and Australia, when they came to this realization a decade ago, abandoned

disclosure as a primary protection strategy and adopted best interest. New Zealand has recently made this change. So must Canada.

It is time for Canadian securities regulators to stop blaming the investor. The product-centric suitability approach to protection, which relies on disclosure "working", ignores fundamental truths and societal norms. It not only harms investors, it has created a regime within which investors can and will be deliberately and intentionally harmed. There is little protection in that.

A 'best interest' approach to investor protection

A 'best interest' approach to investor protection is investor-centric and aligns with regulatory goals and purpose. A best interest standard treats investor interests – individually and as a collective – as paramount. It protects against those who are self-regulated engaging in practices that are self-serving.

The proposed standard would require that registrants deal fairly, honestly and in good faith with their clients and act in their clients' best interests. This includes avoidance of conflicts of interest, which must be identified and managed in a manner that prioritizes the clients' best interests. This requires full, clear, meaningful and timely disclosure of material facts and circumstances affecting the clients' best interests. This requires that dealers and advisers interpret agreements and provide factual information to the clients in a clear and comprehensible manner, so that a consumer choice can be made based upon meaningful information.

Appendix II elaborates the Council's view of how a best interest standard improves consumer protection.

The Council agrees that the proposed regulatory standard closes the expectation gap between consumers who engage with dealers and advisers as retail investors and the actual performance of services provided by them.

The standard mitigates the client-registrant information gap and validates the clients' significant trust in registrants. More than 10 years of efforts to enhance financial literacy of consumers has not closed the information gap to the point at which retail customers deal with registrants on the basis of equality of information and understanding. It never will.

The BCSC has come out against the best interest standard and is in favour of fixing other problems that exist. The BCSC notes: "The proposed targeted reforms are geared to the realities of our current registrant categories and conflicted business models." Why is the reform not geared to investor realities and ensuring there is greater protection from business models and practices that harm the investor? The current reality is that industry interests are consistently put ahead of investor protection and the "targeted

reforms" that attempt to prop up a flawed approach still leave the investor substantially unprotected from real harms.

The Council attaches at Appendix III its specific response to the objections of the BCSC.

Years ago, our provincial governments permitted securities industry self-regulation under the expectation that the regulators would ensure that the playing field stayed level; that self-regulation would not result in self-serving. That expectation has not changed.

Our society has said that buying a home is a big decision for a consumer who will need an expert to help them. In Canada's largest provinces, regulators hold experts to a best interest standard.

Our society has said that filling prescriptions is important to one's health and consumers will need experts to help them take the right medications in the proper way. Experts are held to a best interest standard.

When a retail investor decides to place their life savings in investment products that will afford them to retire, the retail investor will need help from experts to get it right. How can one argue, then, that in this important decision society would not expect the same standard of care? It is our view that individuals do expect the same standard of care – a best interest standard.

The securities industry has demonstrated over the years by its resistance and delaying tactics, that it holds registrants' and their shareholders' interests paramount. It is true that there are some in the industry who act professionally and go about their business holding the investor interest as paramount. It is also true that some in the industry do not, have fought against basic disclosure, delaying for more than a decade disclosure of information that would have been automatically provided to the client from day one, had they the client's best interest in mind.

It is the industry that has promulgated and defended the use of inducements, commissions and embedded commissions notwithstanding a fundamental conflict that arises with the investors' best interest. Not only should best interest be the standard for investor relationships, it needs to be the lens through which all activity – business and regulatory – is viewed; the standard by which all activity is judged. It is the lens through which regulatory oversight and, in particular, SROs oversight must be evaluated and judged.

Benefits of a best interest standard in addressing specific harms

Conflict of interest

The issue of conflict of interest must be addressed by regulators not only at the one-on-one client-facing relationship level, but also at the organizational level, including, product design, marketing, HR, communications, legal, etc. Under a best interest standard, conflicts must be avoided to ensure the investor's interest is not subordinated. That is the expectation. The industry participants are accountable to the SROs for ensuring their business practices conform to this expectation. The SROs are accountable to the provincial securities regulators for ensuring this happens. The SROs are accountable for demonstrating that registrants do not put self-interest ahead of investor interest.

In some situations, a conflict may arise. In those situations, one must ask if the conflict can be "managed". If a registrant decides that the conflict can be managed, the burden of proof falls on the industry/registrant and the SRO to demonstrate that the investor interests have not been and are not compromised notwithstanding the conflict. That, in a nutshell, is what other industries and professions do to protect individual clients, patients, students, consumers, buyers, etc.

This is not a "business-to-business" context. Retail investors do not have means to protect themselves against conflicts and the self-regulated industry must demonstrate on a continuous basis to government and the public that self-regulation has not led to self-serving in those situations when a conflict cannot be avoided.

The Council attaches as Appendix IV some further points on conflicts of interest.

Misleading marketing practices and use of titles

In the securities industry, the practice of using titles that mislead, deceive and confuse retail investors has been deliberate and intentional. It has been done to attract clients, to sell products and to create a halo of expertise and authority where none exist. Not all market participants have done this. Some have behaved professionally. However, this bad behaviour is still so prevalent and so significant that there needs to be a regulatory response. It is a clear example of self-aggrandizement and self-serving behaviour that is not in the interest of retail investors. Titles must be specified and rules set out for when individuals can use which titles. The industry and the SROs have failed badly in self-managing the use of titles. Corrective measures that were put in place in the past failed badly. Therefore, the CSA must respond by making rules on titles. And these rules must be enforced from Day 1.

In the United States, it has been held that if you use a slogan or marketing pitch or a fancy title, then customers can rely on that and hold you to your commitments. What an idea!! In the United States, investors are allowed to rely on the sales pitches and marketing materials they receive. Sadly, this is not the case in Canada and many investors naively and trustingly enter into investment adviser relationships based on promises that the dealer/broker takes off the table the minute things get serious. Those using these practices must be held to account by the regulators so that promises of a worry-free retirement or great investment returns cannot be used to create a halo effect and an initial bias to attract the investor, who is subsequently abandoned. Under a best interest standard, this would be addressed.

Key processes used to serve investors – risk profiling

Within the past year, the Risk Profiling Research carried out by the OSC/IAP uncovered serious deficiencies in practices upon which investment product recommendations depend. The research found that more than 80% of risk profiling tools currently in place are not fit for purpose. The implications are profound and uncover significant harm to investors – past, present and, if not changed, future harm.

Under a best interest standard, registrants would be held to account for flawed processes and would be required to know that the tools and processes they put in place actually work, will need to work in order to be sure that their business practices are in the best interest of the clients.

The Council attaches as Appendix V its further comments on the KYC/suitability method of protecting investors.

Accessible, fair and affordable redress and restitution

In Canada today, unless one is a young wealthy retail investor who can afford the legal costs and live long enough to get justice through the courts, an investor who has been harmed has no access to unbiased recourse. This must be fixed.

Investor redress in Canada is very difficult to obtain through the courts and administrative agencies. The Ombudsman for Banking Services and Investments does not have binding authority to provide redress. Its caseload is but a fraction of the demand for justice. Class actions are few when measured by success for consumers. And they are risky and long-delayed to completion.

Timeliness is an essential component of this principle. Seniors and those who depended on the vanished life savings to pay the bills do not have time to go through lengthy court processes. Seniors are particularly vulnerable in this regard. Loss of savings – compounded by lack of redress/restitution on a timely basis – leads to loss of dignity, health and, at times, life. This is not reflective of Canadian values and society's

expectations. It is wrong that harmed investors should be essentially powerless to do anything but suffer the harm.

The absence of a system of accessible, fair and affordable redress and restitution not only violates the G20 principles endorsed by Canada; it violates the basic notion of investor protection. Without redress and restitution, there is simply no protection for those who are harmed. A regulatory approach that puts retail investor interests first would have, of necessity, provided a system of accessible, fair and affordable redress and restitution many years ago. Now is the time to get that done.

The Council attaches as Appendix VI additional points on the importance of effective legal redress.

The Voice of the Investor

The Council is in the company of other investor-protection oriented organizations calling for better retail investor protection and better investor education, including:

- Canadian Association of Retired Persons
- Canadian Foundation for Advancement of Investor Rights (FAIR Canada)
- Kenmar Associates
- Small Investor Protection Association

Please recognize that you are hearing the voice of 'main street' in the positions of the Council and these other organizations. You are hearing from those who seek to represent the investors you are charged to protect. In these voices, you hear the expectations of the Canadian public from all walks of life whose societal objective of investor protection is already enshrined in law.

Now is the time to align the regulatory regime with that objective – to hold registrants responsible for serving customers in a manner that meets or exceeds that objective and holds the retail investors' interests as paramount. Do not be dissuaded by handwringing that may come from those who have treated investors unfairly and profited over the years by putting their own business interests first.

The Council encourages the CSA and provincial regulators to move quickly but not hastily to implement its recommendations to bring retail investors the protection they deserve. Other jurisdictions have demonstrated that implementation of a best interest standard need not take decades to achieve. Let us learn from their work and together to get on with the job of protecting consumers of financial services.

Appendices

Appendix I - Investment Adviser Expertise 2

Appendix II – The Incremental Nature of the best interest standard 3

Appendix III – The BCSC Objections 4

Appendix IV – The Conflict of Interest Between Investment Advisers and Clients 9

Appendix V – KYC and Suitability 10

Appendix VI – The Necessity of Effective Legal Redress 11

OBSI is not a satisfactory alternative means of legal redress 12

Appendix I - Investment Adviser Expertise

What kinds of skills should investment advisers possess and bring to the client relationship? The most critical skill is the ability to assist the client in planning their financial future. In this respect, the adviser must have the expertise to lay the groundwork for sound advice and good planning, including helping the client understand her/his ability and need to bear financial risk and her/his comfort in taking financial risk. In many cases, ability, need and comfort are not aligned and the adviser must help the client reconcile these with a view to the client's financial objectives and best interest.

The most important decision the adviser can help the client make relates to asset allocation; that is, choosing what proportion of assets should be invested in equities, and what proportion should be invested in very low risk assets such as bank accounts, treasury bills, GICs, and so on. The importance of the asset allocation decision derives from standard financial theory.

The asset allocation decision depends not only on risk preference, but also on time horizon and cash flow needs. Young investors with a long time horizon and low cash flow needs can weather downturns in the equity market relatively easily. Older investors on the cusp of retirement cannot. Similarly, investors with modest immediate needs for cash can afford to take higher risks; investors with significant and pressing cash flow needs (such as those with families, large mortgages, etc.) cannot.

Some investment advisers profess to have specific skills in selecting securities. Many direct their clients into active stock-picking strategies. Most evidence suggests this ends up contrary to many clients' best interests. Many investors would be better served by adopting a lower-cost passive investment strategy. But lower cost index investments are less lucrative to advisers, creating a massive conflict of interest between investment advisers and their clients that can divert advisers from recommending more, lower-cost investments.

This analysis suggests that large numbers of investment advisers currently possess the wrong expertise to best assist their clients. Clients will typically derive much greater benefit from expert financial planning than from generally unhelpful advice about which securities to buy and sell.

The Council hopes that securities regulators will turn their minds to changing, or at least augmenting, the nature of the financial expertise possessed by investment advisers and applied in a client-relationship context, in order to better ensure that Canadians rationally and intelligently plan their financial futures and make their retirements more secure.

Appendix II – The Incremental Nature of the Best Interest Standard

At present, investment firms and their representatives are required to deal with their clients fairly, honestly, and in good faith.

This requirement comes close to replicating various statutory fiduciary duties, such as the corporate law duty owed by directors and officers. That duty requires directors and officers to "act honestly and in good faith with a view to the best interests of the corporation". There are thus two differences. The corporate standard requires that directors and officers act "with a view to the best interests of the corporation", while the investment standard includes the work "fairly", while the statutory fiduciary duty does not.

The first difference is commonly supposed to make the investment standard less extensive than the corporate standard. However, in the corporate arena, the courts have held that the requirement to act in the best interests of the corporation adds nothing to the requirement to act honestly and in good faith. The first implies the second. Thus, the absence of the words "best interests" in the investment standard arguably makes no difference, and the duty currently imposed in investment firms and their advisers is a fiduciary standard. Our courts, however, do not seem to recognize this. Therefore, it seems that the regulations must be made more explicit.

Second, as noted, the investment standard requires the investment firm to deal fairly with its clients. The requirement to act "fairly" is the essential underpinning of the statutory oppression remedy in corporate law. The fairness standard has been interpreted by the courts as creating a duty that is wider than the statutory fiduciary duty. Thus, the inclusion of the word "fairly" in the investment standard can be interpreted as making the investment standard wider than the statutory fiduciary duty.

Investment firms are subject to a variety of other broad textured duties, such as the duty to act ethically, not against the public interest, in accordance with just and equitable principles of trade, etc. It is the totality of these duties that is important in defining the standard to which investment firms must adhere, and the aggregate effect could easily be interpreted as specifying a fiduciary standard of conduct. If so, appending the best interest standard to the current formulation of the investment duty is, in effect, carrying coals to Newcastle.

But in any case, whether the current formulation of duty does or does not create a true fiduciary duty, the addition of the best interest standard effects a natural and incremental addition to the current standard.

Appendix III – The BCSC Objections

In response to the objections of the BCSC, the Council submits that the uniformity of standards recommended by the CSA should be encouraged. BCSC, in its stated opposition, is an outlier in its resistance to the best interest standard.

BCSC indicates that "the adoption of a broad, sweeping and vague best interest standard will create uncertainty for registrants and may be unworkable in the current regulatory and business environment."

The BCSC also states: "the CSA should establish clear requirements for registrants to follow and regulators and courts to enforce."

The Council does not agree with these comments. While a broad textured standard such as the best interest standard necessarily lacks the specificity of detailed rules, it is (as noted above) a vital gap-filling device that addresses the inability of any regulatory regime, no matter how precise and no matter how well thought out, to anticipate every fact situation that may arise.

It should be noted that, at present, both investment firms and their advisers are subject to a wide variety of broad-textured rules. These include, for example, the duty under various IIROC and securities regulatory rules to ensure that the handling of client business is within the bounds of ethical conduct; to deal fairly, honestly and in good faith with its clients; to ensure that the handling of client business is consistent with just and equitable principles of trade; to ensure that the handling of client business is not detrimental to the interests of the securities industry; to ensure that the handling of client business is not detrimental to the interests of the securities industry; to refrain from engaging in any business conduct or practice which is detrimental to the public interest; to ensure that the acceptance of any order for any account is within the bounds of good business practice; and to display absolute trustworthiness in all dealings with clients. Indeed, in IIROC decisions dealing with registrant misconduct, the rule of most frequent application is the "conduct unbecoming" rule (i.e. the rule that registrants "shall not engage in any business conduct or practice which is unbecoming…"). The conduct unbecoming rule, like the proposed best interest standard, is a gloss that applies to the execution of each and every other rule imposed by IIROC on registrants, including the Know Your Client, Know Your Product, and suitability duties.

The best interest standard is far more precise than most or all of the aforementioned broad textured standards. It is a clear instruction that in every interaction between registrant and client, the client's interests are paramount. This is far more precise than, for example, the "conduct unbecoming" rule, the injunction not to act contrary to the interests of the securities industry, and the injunction not to act contrary to the public interest.

What the best interest standard entails must be interpreted according to the nature of the relationship between the registrant and the client. A registrant, for example, that offers only order execution services (e.g. a “discount broker”) cannot be expected to have the same duty to its clients as a registrant administering a fully managed account. The responsibilities of the latter to the client are necessarily far more extensive than the former.

Having said this, the best interest standard can be tailored to specific categories of relationship based on the nature of the registrant’s function. A discount broker, for example, cannot be expected to give investment advice, and cannot be faulted for executing a client-ordered transaction that is not suitable for that client. Indeed, such brokers are forbidden from giving investment advice of any kind, directly, indirectly, explicitly, or implicitly, and as a corollary are specifically exempted from the suitability obligation. Nonetheless, multiple platforms exist for effecting order execution (including both stock exchange trading engines and various alternative trading systems). Thus, a client order can be executed in many different ways. Importantly, some of these prioritize the broker’s interest over that of the client. This might be so, for example, when an order is executed on a trading platform in which the broker has an ownership interest, if better execution (e.g. execution that is cheaper, faster, or at a better price) is available on another trading platform. In this context, the best interest standard should be, and can be, limited to the service that the broker is actually providing the client. For such brokers, the best interest standard would do more than merely piggyback on industry rules addressing “trade throughs”; it would add a needed gloss to these rules and remind brokers that, in effecting order execution, the client’s interest is paramount.

Clients have varying degrees of sophistication and place varying degrees of trust in their investment professionals. The nature of what is required to act in the best interests of different clients must take these differences into account.

But this does not mean that the best interest standard cannot be tailored to individual situations based on a factual analysis. The suitability obligation supplies a useful precedent. Aside from registrants offering only order-execution services, the suitability obligation arises even in respect of the most sophisticated retail clients.[15] The nature of the suitability obligation is tailored to the factual underpinning of the relationship. The same can be done with the best interest standard.

At present, in deciding whether a fiduciary obligation arises between a registrant and client, the courts conduct an extensive examination of the facts to determine the extent

[15] The only exception, aside from registrants offering only order-execution services, arises in respect of retail clients with net financial assets in excess of $5 million (so-called “permitted clients”).

to which the client relied on, and placed trust and faith in the registrant. A decision is made on a bimodal basis: i.e. either a fiduciary duty arises or it does not. This is unfortunate. Characterizing a relationship as either fiduciary or non-fiduciary has highly material legal consequences, both with respect to liability and to damages. Rather than applying a knife-edge test, it is more appropriate to assess the degree of trust, reliance, and vulnerability of the client, and tailor the extent of liability and responsibility for damages to the specific facts, rather than employing an all-or-nothing approach.

Adoption of the best interest standard will supply an opportunity to remedy this deficiency. The content of acting in a client's best interests can and should be tailored not only to the category of investment relationship, but to the specific facts at hand.

The BCSC also worries that "the proposed standard will not prohibit certain fundamental conflicts between registrants and their clients" and that this is inconsistent with the adoption of a best interest standard. The Council does not agree. Again, corporate law supplies a precedent. Even though corporate directors and officers are impressed with a fiduciary duty that requires them to "act honestly and in good faith with a view to the best interests of the corporation", corporate and securities laws allow certain conflicts of interest to exist. These include, for example, permission for directors and officers to enter into related-party transactions with their corporations, and to set their own remuneration. Dangers inherent in such conflicts of interest are handled through a combination of merit and disclosure rules. The former include rules indicating the circumstances in which conflicts will be tolerated, and specifying procedural requirements (such as shareholder approval) that must be met in order to escape liability. The latter include requirements to disclose the nature of the conflict of interest to shareholders and the public.

The same may be said with respect to the investment business; conflicts of interest can be handled in much the same way as they are in corporate and securities law. The CSA Proposal specifically requires registrants to deal with conflicts of interest in a manner that prioritizes client interests.

If the best interest standard makes it difficult for certain market actors to continue to offer certain products, or to operate in the manner in which they now do, this is not a negative outcome in the Council's view. If practices currently employed by investment firms are materially at odds with client interests, then there is little reason to believe that such practices should be encouraged to continue.

An example is the use of funds paying sales commissions and trailer fees on mutual funds. Paying a commission to an adviser for placing a client in a particular mutual fund represents an inducement, which an adviser may seek to obtain in their own best interest, not the client's. As the CSA request for comments notes, academic research indicates that the performance of many of such funds commonly lags that of no-load

funds. Service that does not pursue the best interest of clients through cost-effective portfolio construction should not continue.

The Council is not troubled by the fact that these products may currently satisfy the suitability standard but not the best interest standard. As noted by the OSC and the FCNB, what is of vital importance is that the legal framework be set up so that Canadians are given the best opportunity to get their financial house in order in preparation for retirement. From a policy point of view, the protection of existing market practices and products that are inimical to this goal does more than merely pale in importance; it is at odds with the efficiency of Canadian capital markets and the welfare of Canadian investors.

The BCSC also states:

> If regulators impose a standard that is called a best interest standard, but at the same time permit fundamental conflicts to continue, they run the risk of contributing further to this problem by leading clients to believe that they are getting protections they are not. The proposed standard may therefore exacerbate the gap between what clients expect and what is actually permitted.

However, there will be no broadening of the expectation gap if registrants are clearly required to disclose these conflicts to clients, and to make sure that clients fully understand their import. Moreover, the BCSC's view ignores the fact that the best interest standard is an important element in addressing the broad expectation gap that currently exists, as numerous studies have demonstrated. The BSCS's objection, in effect, seeks to throw the baby out with the bathwater and ignores the reality that many professions and self-regulated industries arrived at acceptable solutions years ago.

Every agency relationship is characterized by conflict. A lawyer may be tempted, for example, to draw out litigation in order to earn more substantial fees. A corporate board of directors may decide to fight a hostile takeover bid only so that its members may retain lucrative directorships. An investment adviser may recommend a trading strategy that is not appropriate for a client in order to earn greater commissions. It is precisely because of these conflicts, and the inability to anticipate each and every conflict in advance, that fiduciary duties exist. The existence of conflicts is not anathema to a best interest standard; it is the very reason for such a standard.

So, the Council does not agree with the BSCS when it asserts the standard will "exacerbate the gap between what clients expect and what is actually permitted."

Clients currently place a great deal of trust in their investment advisers. It is very unlikely that the creation of a best interest standard will result in a materially higher level of trust, given that a very high level of trust already exists. Moreover, most retail clients are not knowledgeable about the details, or even the broad-brush strokes, of their legal

relationship with their adviser, and the adoption of the best interest standard cannot be expected to change investors' expectations.

Like the Ontario Securities Commission and the Financial Consumer Services Commission, the Council believes that adopting the best interest standard will result in a fundamentally better alignment between client expectations and the legal matrix of rules governing the registrant/client relationship.

The BCSC also states that "some jurisdictions' securities laws requiring portfolio managers and dealers with discretionary authority and investment fund managers to act in the best interest of their clients", and:

> These laws refer to registrants having to act in the client's best interest and are intended to establish true fiduciary standards. The Jurisdictions with Concerns about a BIS think adopting a standard that requires other registrants to also act in their client's best interest, but that is qualified to mean something less than a full fiduciary standard may impact the interpretation of the words "best interest" as they apply elsewhere.

As expressed already, the Council does not agree that the best interest standard is not a fiduciary standard. At the risk of waxing colloquial, if it walks like a duck and quacks like duck, it's a duck. The best interest standard is a fiduciary standard of conduct, and seeking to label it as something else does not change its fundamental nature.

Appendix IV – The Conflict of Interest Between Investment Advisers and Clients

The regulatory and legal regime that applies to investment firms and their various employees must address the potential for conflicts of interest between investment advisers and their clients.

This topic was addressed in the CSA Consultation Paper.

The CRM requirement for disclosure of trading commissions and returns are important developments. Financial consumers should know the cost of the services they receive. However, we agree with the OSC and the FCNB that disclosure, by itself, falls far short of fully addressing the conflict. Nor does it address the expectations gap so graphically illustrated by the studies cited in the CSA CP. A best interest standard is absolutely required to help align the interests of clients and registrants.

Appendix V – KYC and Suitability

The Consumers Council of Canada supports reform to the KYC/suitability obligations, including the following:

1. Requiring the investment adviser to develop a complete financial profile for each client.
2. Requiring the investment adviser to develop a risk profile for each client.
3. Requiring both initial KYC and subsequent updates to be verified by a compliance person.
4. Requiring the investment adviser to update the KYC information at least once a year.
5. Making it clear that the suitability obligation extends not only to each and every trade in the client account, but to the suitability of the account type, the suitability of the trading strategy, the adequacy of diversification in the client's portfolio, the liquidity of the portfolio, and other risk factors such as foreign exchange risk (note that all of these factors have been identified by the courts as being a part of the suitability obligation).
6. Making it clear that where the account is fully managed (or is managed by a third-party adviser) the suitability obligation includes keeping the client informed of any material change to the investing strategy.
7. Making it clear that if a trade is not suitable, the investment adviser should refuse to execute the trade, unless the client has demonstrated that she/he is sophisticated and acknowledges in writing that he/she has been advised that the trade is unsuitable.
8. Making it clear that the suitability obligation includes trading and product costs.
9. Making it clear that the suitability obligation extends to not "churning" the portfolio (in a managed account) or permitting the client to engage in excessive trading that results in an unsuitable level of trading/product costs (in a non-managed account or an account managed by a third party).

Appendix VI – The Necessity of Effective Legal Redress

The Council recommends the principle that "consumers have access to adequate complaints handling and redress mechanisms that are accessible, affordable, independent, fair, accountable, timely and efficient."[16]

At present, clients who feel that they have been harmed or abused by their investment advisers have very limited options in seeking accessible, affordable and timely redress from an independent, objective party. The reality is that litigation is simply not an option for most investors. This is because:

1. Litigation is extremely expensive. It is not unusual for the aggregate expenses of litigation to run into the hundreds of thousands of dollars (on each side). Most investors will balk at the financial burden of undertaking litigation, even if they believe that they have an extremely strong case.
2. There is an enormous disparity in resources available to plaintiffs (clients) and defendants (registrants). In almost situations, registrants have sufficiently deep pockets that funding litigation will not put any kind of strain on their financial resources. By contrast, retail clients are often highly constrained financially, and many will be completely unable to fund litigation.
3. The aforementioned problem is exacerbated by the fact that there are very few lawyers who will take claims of this nature on a contingency basis. Thus, only well-heeled clients with ample cash flow can afford to undertake litigation.
4. The asymmetry of resources between defendants and plaintiffs allows the defendant to spend far more on lawyers and experts than the plaintiff, tipping the scales in the defendant's favour.
5. The very losses that the client has experienced operate as a constraint on the client's financial resources. By contrast, the defendant will have experienced loss – and indeed will typically have profited from the client's trading. Thus, the asymmetry of financial resources is exacerbated by the losses that the client is complaining about.
6. It is not only the cost of litigation that deters many potential plaintiffs, but risk. Even where the client believes that he/she has a very strong case, the outcome of litigation can never be predicted with anything like perfect certainty. If the client loses, then he/she will not only have to cover his/her own costs, but a considerable

[16] *High-Level Principles on Financial Consumer Protection* endorsed by the G20 Finance Ministers and Central Bank Governors in 2011

portion of the defendant's costs. The aggregate costs can easily run into many hundreds of thousands of dollars, posing the risk of utter financial ruin for the plaintiff if the suit is lost.

7. Our legal system is extremely slow; civil cases involving clients suing investment-banking firms usually drag on for many years. Indeed, the deep-pocketed defendant has every incentive to draw out the litigation as long as possible in order to wear down the plaintiff and encourage him/her to abandon the claim or settle for far less than its true value.
8. Litigation has an emotional cost for retail investors not shared by the registrants. While the investor faces an enormous and possibly crippling financial loss if the suit is lost, the typical defendant can easily absorb a loss with little prejudice to its bottom line. The defendant, not being a natural person, experiences no emotional burden. Individual registrants, such as investment advisers, who also may be sued will very often have liability insurance. Even if they do not, they are typically in a better position to defend an action and absorb any loss – and will typically share that loss with their employer.

OBSI is not a satisfactory alternative means of legal redress

Distressed investors might enlist the services of the Ombudsman for Banking Services and Investments ("OBSI"). OBSI hears complaints up to a loss limit of $350,000. It does not charge the complainant to receive and assess complaints. If OBSI believes that an investor has been wrongly treated, it will make a recommendation for compensation. OBSI has made and continues to make an important contribution to investor protection.

However, there are problems.

One of these is the $350,000 limit on the amount of compensation that OBSI will recommend. This means that in the most serious cases of investor harm or abuse, OBSI is simply not an alternative. These are often cases in which the large financial losses suffered impair the investor's ability to use the courts to seek redress.

OBSI's recommendations are not binding. OBSI makes recommendations to the parties They may or may not be accepted by the registrant. This seriously impairs the implementation of its mandate. As noted in the "Independent Evaluation of the Canadian Ombudsman for Banking Services and Investments' (OBSI) Investment Mandate" (May 2016) (p.1) (the "Independent Report"):

> OBSI is unlike other comparable international financial sector ombudsmen in that it does not have the authority to bind firms to observe its compensation recommendations (binding authority). This drives its operating model and prevents it from fulfilling the fundamental role of an ombudsman, securing redress for all consumers who have been wronged:

- in 2015, 18% of non-backlog complainants who OBSI considered should receive compensation received less than OBSI recommended (on average $41,927 less); including 3.5% who were at risk of receiving nothing.

OBSI recommendations for settlement may well be more modest than they would be if OBSI's findings were binding, since OBSI's limited resources create an incentive to secure a settlement and move on to assist other complainants.[17]

For these reasons, the Independent Report states:

> Moreover, it is more difficult to confidently promote a service that is unable to assure and secure redress for consumers.
>
> In our view, therefore, OBSI is not a true industry ombudsman; it is a dispute resolution service.

The Council agrees with the Independent Committee's recommendations for the reform of OBSI, including the recommendation that OBSI awards be binding on investment firms. This is an essential and missing ingredient for effective investor protection.

[17] The Independent Report states (p.1):
Without the ability to secure redress in all cases, it is difficult to fairly compare OBSI's performance with international counterparts. OBSI's mandate has, however, led to:

- an operating model that is inherently inefficient – it is overly focused on resolution through negotiated settlements rather than judicious use of determinations
- longer resolution times
- the risk of creating future backlogs