September 30, 2016

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
The Manitoba Securities Commission
Financial and Consumer Services Commission (New Brunswick)
Nova Scotia Securities Commission
Ontario Securities Commission
Financial and Consumer Affairs Authority of Saskatchewan

Joseé Turcotte, Secretary
Ontario Securities Commission
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Me Anne-Marie Beaudoin, Corporate Secretary
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Dear Mesdames and Sirs:

RE: CANADIAN SECURITIES ADMINISTRATORS CONSULTATION PAPER 33-404: PROPOSALS TO ENHANCE THE OBLIGATIONS OF ADVISERS AND REPRESENTATIVES TOWARDS THEIR CLIENTS

Thank you for this opportunity to comment on CSA Consultation Paper 33-404 (CSA 33-404).

A "buy side" industry participant for several decades, I have managed money and teams of portfolio managers providing institutional investment advice to governments, corporations and pension plans, and retail advice to individuals, mutual funds and other advisers. I lecture and write about risk management and portfolio construction in Canada and abroad while leading a team focused on autonomous portfolio systems, software and algorithms for individuals. I have been a registrant under the Securities Acts in Canada and the Investment Companies Act of 1940 in United States.

Staff is to be commended for their efforts to enhance the obligation of advisers, dealers and representatives towards their clients as described in CSA 33-404. Getting advisers to put clients' interests ahead of their own reflects in legislation what investors already believe is the obligation owed to them so "closing the expectations gap" not only makes sense, but is also the best way to bring information asymmetry into better balance by aligning advisers' and investors' interests. The reforms address the key issues, but as proposed, are complex and may actually jeopardize investor choice, product innovation, and the desired impact of conflict of interest disclosure. A simpler and more consumer-friendly tact would promote better understanding and faster acceptance.

CHALLENGES

Some CSA 33-404 proposals will have unanticipated adverse consequences. For example, the logical outcome of KYP proposals is the narrowing of product shelves that may not only make innovation more difficult than is already the case but may encourage reciprocal product agreements (collusion) between product provider/distributors, like major financial institutions. To reduce the regulatory burden, advisers may increasingly use proprietary pooled fund products to the detriment of investor choice and the pursuit of personal investment solutions. Some advisers will consider regulatory arbitrage (segregated funds) to avoid the new proposals. Furthermore, recent research[1] suggests that the timing and availability of disclosure may lead to tacit approval of conflicts of interest, contrary to the intent of the regulations.

Costs could be material as the U.S. Department of Labor's decision on a fiduciary standard for retirement products is suggesting[2]. Higher costs and less choice are contrary to investor best interests.

On the other hand, concerns about reduced access to financial planning and investment advice with the elimination of embedded commissions, while correctly reflecting the aging demographics of the advice profession, misses the fact that new demands will engender new opportunities. The spread of low cost robo-advisers is an example of how technology can help and why new and innovative approaches should be encouraged by the industry and regulators.

BACKGROUND

The expanding role of compliance departments and securities regulations is in part a response to advisers compromising their duty to investors by:

- increasing reliance on embedded commissions or other conflicted compensation[3];
- being held to the low standard of product rather than portfolio suitability;
- using titles that do not better inform misguided investors' belief that a statutory best interests standard already exists.

My recommendations are based on three principles:

1. Compensation drives behavior. Structuring adviser remuneration to promote client interests first is preferred to disclosure alone.
2. Portfolios get investors to their goals not individual investment vehicles in isolation.
3. Simple, salient, and timely disclosure coupled with clear common-sense labelling of products, advisers and customers would improve understanding by all participants.

What gets measured can be used to drive positive industry change. Rating advisers and their firms on key metrics including costs, expertise and products/service fit will motivate participants to improve their rankings and with social media's help, better engage emerging generations of investors.

RECOMMENDATIONS

A principles-based approach that, with regulatory guidance, places the burden of addressing conflicts of interest, costs, and investor outcomes on competitive market forces would be more effective than a codified approach and promote better alignment of adviser and dealer interests with those of their clients and customers. Specifically, independent scoring of key metrics would encourage participants to improve their product suites and service standards.

Conflicts of interest

Investors benefit when advisers' interests are aligned with their's. Fee-based compensation best aligns these interests. Commissioned sales, even with disclosure, places those advising clients in a conflicted position and should be restricted to dealers, representatives and those clearly labelled as "salespersons" (see business titles, below). Conflicts from embedded commissions can't be supported and should be eliminated.

Rebating all compensation due to an adviser, an adviser's firm or affiliates from a product, like mutual fund trailing commissions, together with proper notification, is an approach already followed by some portfolio managers and should be made mandatory for all with discretionary control of client portfolios.

The purpose of disclosing conflicts of interest is to give investors the means to make more informed decisions that lead to better outcomes. But disclosure can decrease trust and place an additional burden on disclosees to accept compromised products or services to avoid conflict and adviser disappointment. As a result, disclosure may not only confuse decision-making, but may embolden those with conflicts[1].

Example: An adviser spends two hours discussing personal financial goals and obligations and reviews an existing investment portfolio with a prospective client. After a week, the adviser returns with a financial plan, a proposed investment policy statement and new portfolio. The adviser discloses she offers only mutual funds from a single provider and that other products are available at lower cost that may offer better results over time. Given the work done, time expended, and personal relationship created, the prospective client may feel an obligation to accept the plan and hire the adviser even though the limited choice and higher cost investment options are sub-optimal. The prospect may not want to disappoint the adviser by denying her a commission.[4]

Better outcomes may not result. Disclosure alone is not a sufficient remedy for dealing with conflicts of interest. The timing of the disclosure is also critically important.

Advisers and their firms could manage and control conflicts of interest, reduce client costs, and provide better fee-based services on their own if they were scored on key metrics that are uniformly defined and if trusted results were readily available (online) to their clients, customers and prospects.

Know -your-client (KYC) requirements

Needs and objectives, financial circumstances and risk tolerance are KYC's key metrics, but "understanding" a client cannot be codified. Attitudes, circumstances and reactions to capital markets

change over time and by adviser. The range and scope of a registrant's services will dictate and define "thoroughness". A financial planner will need more information about personal circumstances including taxes, an investment adviser more about risk tolerance and objectives, and a dealing representative, enough to discern product suitability. Advisers encompass a broad range of knowledge and skills so an attempt to make them the same may diminish specific strengths and specialties that provide strength for the industry.

Stipulating a standard KYC form would be useful for firms currently lacking a comprehensive approach or who are looking to abrogate their responsibility by using a prescribed form. However, each firm and/or adviser may have a unique interpretation of the responses. In the end, a uniform KYC questionnaire can capture many pertinent facts but does not ensure that advisers or their firms will consider them when making a recommendation regardless of who signs it.

Know-your-product (KYP) requirements

Understanding product structures, features, costs and risks are fundamental to each adviser's responsibility. However, as for KYC above, the emphasis changes with the nature of the registrant's duty. Dealers and their representatives need comprehensive product knowledge because that is what they are selling. Investment advisers need to know how to control and manage risks. This is more about the portfolio construction process than the ability to list all product characteristics. Nevertheless, the easiest way for adviser firms to deal with proposed reforms is to limit product shelves. The beneficiaries of this restriction will be existing product providers with the largest and most liquid offerings. Access to innovative products will be limited. When distribution is restricted, the environment for reciprocal market arrangements and other practices to ensure shelf space is encouraged and the loser is the investor.

Investment advisers will need to understand the impact of products on client portfolios and investment strategies. This leads to the issue of suitability below.

Suitability obligation

Portfolio suitability should replace product suitability as the primary focus for advisers. The combination of investment instruments is more important than individual securities in managing risk and getting investors to their goals. Redefining risk and performance to support the ideas of limiting losses and achieving goals frames the objective for portfolio suitability. The progress towards achieving a financial goal, like sufficient capital to replace a level of income in retirement, should replace rate of return as the focal point for performance. Most investors have real life objectives that their investments should address. The industry's incessant pursuit of returns, risk-adjusted or otherwise, may not always suit their needs or tolerance for losses.

Securities and mutual fund sales people, commissioned or salaried, can retain product suitability requirements because their duty to clients does not include portfolio construction expertise.

Business titles and obligations

Clear labelling of investments is a cornerstone of securities regulations. The same principles should be applied to advisers, consumers and adviser obligations. These disclosures are fundamental to understanding the products, services and standards of duty offered by the industry particularly in the absence of broad and uniformly acceptable levels of financial literacy. Here are some suggested guidelines.

Adviser: Stipulated adviser labelling that describes:

1. adviser compensation (fee-based, salaried, commissioned);
2. professional or commercial nature of the relationship (investment adviser, financial/estate/tax planner, securities/mutual fund salesperson);
3. product breadth, conditional label only for those with restricted product shelves (single provider funds, pools, etc.).

Examples: fee-based investment adviser, commissioned securities salesperson, salaried mutual fund salesperson, commissioned single fund company salesperson.

Consumer: Reinforces the adviser's duty.

1. Client: only for use by fee-based advisers with a fiduciary duty.
2. Customer: for use by salespersons (commissioned or salaried).

The use of the term "client" implies the recipient of professional advice. A customer is someone to whom a product is sold.

Obligations: Informs investors about an adviser's standard of duty.

Investors believe advisers must, by regulation, act in their best interests[3]. Today, this is only the case for retail investors when discretionary management is involved and then only in certain jurisdictions (by common law in the others). Beyond requiring a fiduciary standard be uniformly required for discretionary management (that is to be commended and supported), nothing anticipated by CSA 33-404 suggests a straightforward conflicts-of-interest-free standard will be required for all registrants. Disclosing the standard of duty offered by the advisor would help consumers make more informed choices and better understand the scope and limitations of their advisor relationship.

1. Portfolio managers and advisers with discretionary power: "This adviser is required to place investor interests before their own or those of their firm or affiliates with no conflicts of interest".

2. Investment and mutual fund advisers without discretion with open product shelves: "This adviser is not required to place investor interests ahead of their own, those of their firm or its affiliates. Products are selected from a broad sample reflecting suitability based on cost, diversification, tax efficiency, investment time horizon, income and risk of loss."

3. Investment and mutual fund advisers without discretion with limited product shelves: “This adviser is not required to place investor interests ahead of their own, those of their firm or its affiliates. Products are selected from a restricted list. Other products may be available with lower cost, better diversification, better tax efficiency, higher income and lower risk of loss.”

4. Dealers and representatives: “This salesperson is not required to place investor interests before their own, their firm’s or those of affiliates. They are required only to recommend products that are suitable for investors based on risk tolerance, investing time horizon, and income requirements.”

Rating Advisers

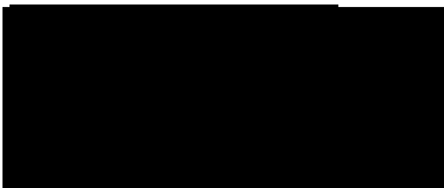
Using the previous example, before the meeting is arranged, the adviser is required to disclose a “C” rating for product costs (indicating relative high costs), an “A” rating for financial planning (indicating the quality of process for an area of expertise), and a “D” rating for conflicted compensation (indicating restricted product choice and commission-based compensation). The prospect can choose whether to schedule a meeting before creating unintended obligations that may lead to poor decisions.

By using a simple rating scheme, the prospective investor is not required to learn about the differences in products or registration categories or the impact of individual material conflicts of interest. Importantly, the adviser and her firm are motivated to improve their ratings. A focus on lower cost products, expanding the product shelf for more choice and adopting fee-based compensation could all help to improve ratings.

CONCLUSIONS

Aligning advisers’ interests with their clients’ is the most effective way to balance the information asymmetry that exists today. If properly implemented, lower costs and a focus on getting investors to their financial destinations will result. Informed investor choices can only come from a clear understanding of the standard of duty to which advisers are held in clear and straightforward terms. Creating the environment for healthy competition among advisers to offer low cost and effective solutions and advice would be more efficient than trying to codify adviser behaviour that would lead to higher compliance expense and less investment choice.

Yours truly,



Mark S. Yamada
President & CEO

[1]Sunita Sah, George Lowenstein, “Nothing to Declare: Mandatory and Voluntary v Disclosure Leads Advisors to Avoid Conflicts of Interest”, Pyschological Science, 2014, Vol.25(2) 575-584

[2]Oxford Economics “Economic Consequences of the U.S. Department of Labor’s Proposed New Fiduciary Standard”, Financial Services Institute, August, 2015.

[3]CSA Discussion Paper 81-407 Mutual Fund Fees.

[4]Sunita Sah “The Paradox of Disclosure” New York Times, July 8, 2016