Notice and Request for Comment

Draft *Regulation to amend Regulation 31-103 respecting Registration Requirements and Exemptions*

Draft amendments to *Policy Statement to Regulation 31-103 respecting Registration Requirements and Exemptions*

Cost Disclosure and Performance Reporting

Introduction

The Canadian Securities Administrators (the CSA or we) are seeking comment on proposals to amend *Regulation 31-103 respecting Registration Requirements and Exemptions* (Regulation 31-103 or the Regulation) and *Policy Statement to Regulation 31-103 respecting Registration Requirements and Exemptions* (the Policy Statement). We refer to the Regulation and Policy Statement as the "Instrument".

Regulation 31-103 came into force on September 28, 2009 and introduced a new national registration regime that is harmonized, streamlined and modernized. We published amendments to the Instrument on April 15, 2011 which, subject to approvals, including ministerial approvals, will come into force on July 11, 2011[1].

We are now proposing additional amendments in the context of the Client Relationship Model (CRM) Project, as described in this Notice, which, if adopted, would introduce performance reporting requirements and enhance existing cost disclosure requirements in the Regulation.

The draft amendments to the Instrument are published with this Notice. The draft amendments are further to those in the amended Instrument published on April 15, 2011.

The comment period ends on **September 23, 2011**.

Background

The CSA, and the Investment Industry Regulatory Organization of Canada (IIROC) and the Mutual Fund Dealers Association of Canada (MFDA) (together referred to as the self-regulatory organizations or SROs), are working to develop requirements in a number of areas related to a client's relationship with a registrant. This initiative is referred to as the CRM Project. As part of this work, the CSA has already developed requirements relating to:

- relationship disclosure information delivered to clients at account opening
- comprehensive conflicts of interest requirements

These requirements were included in the Regulation when it came into force.

The amendments outlined in this Notice relate to the remaining elements of CRM, specifically:

- disclosure of charges related to a client's account and securities transactions
- account performance reporting

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[1] After the amendments come into force, Regulation 31-103 will be re-named "*Registration Requirements, Exemptions And Ongoing Registrant Obligations*".

Contents of this Notice

This Notice gives an overview of the proposed cost disclosure and performance reporting amendments to the Instrument. It is organized into the following sections:

1. Purpose of the draft amendments and impact on investors

The purpose of the draft amendments is to ensure that clients of all dealers and advisers (registrants), whether or not the registrant is a member of an SRO, receive clear and complete disclosure of all charges associated with the products and services they receive, and meaningful reporting on how their accounts perform.

We think that this is a significant investor protection initiative since we are of the view that investors want this type of information and should be entitled to receive it. Many investors do not understand, or are not aware of, all of the charges associated with their investment products and the services they receive. These charges are often buried in the cost of the product or in the prospectus, or are only mentioned briefly at the time of account opening.

The draft amendments are intended to provide investors with key information about their account and product-related charges and the compensation received by registrants. This information would be provided at relevant times, such as at account opening, at the time a charge is incurred and on an annual basis.

Similarly, many investors do not receive any information about how their account is performing. If they do, the information is often complex and difficult to understand. We expect that providing investors with clear and meaningful account performance reporting will assist them in evaluating how well their account is doing and provide them with the opportunity to make more informed decisions about meeting their investment goals and objectives.

If adopted, the draft amendments will result in investors receiving additional reporting from their registrant:

- a new annual summary of all account-related and product charges, and other compensation received by the registered firm
- the original cost of each security added to account statements
- annual account performance reporting

These reporting proposals are outlined in detail in section 3 of this Notice.

2. Investor research and industry consultations

To assist us in developing the draft amendments, we sought feedback from investors to assess and evaluate their understanding and expectations relating to account charges and performance reporting. We also sought feedback from industry participants on current performance reporting practices, and the costs and benefits of providing additional disclosure in the areas of charges and performance reporting. We thank everyone who provided feedback during the research and consultation process. We also appreciate the input provided by the SROs during the development of the proposals.

Investor research

In July 2010, we surveyed approximately 2,000 investors to learn more about their understanding and expectations relating to charges and disclosure, and performance measures and reporting. The report on this survey, *Report: Performance Reporting and Cost Disclosure*, prepared by The Brondesbury Group is or will be available on the websites of CSA jurisdictions (see section 11 of this Notice, Where to find more information).

We learned from the investor survey that:

- most investors do not have the information they need to make an informed judgment about their account

- showing information in technical terms is often the same as not showing it at all because investors will tend to ignore complex data or terminology that they don't understand

- it cannot be assumed that investment and performance terms are well understood by investors

- regardless of the amount invested, information provided in a simple fashion is desired and understood by most investors

- more detailed reporting is of far greater interest to investors than more frequent reporting

The investor research provided us with useful information on the type of information investors want to receive from their dealers and advisers. The research also identified areas where investors need more guidance or disclosure. We considered all of this information in developing our proposals.

Industry consultations

We also conducted industry consultations with dealers and advisers to gain insight into current performance reporting practices, and to identify issues and concerns with providing performance information.

We learned that many registrants already provide some or all of the information required in the draft amendments to their clients or certain groups of their clients. However, some raised concerns about the potential costs, time and resources that would be required to prepare performance information, especially if systems need to be modified.

In response to these concerns, we have provided for a phased introduction of the proposed new requirements. We believe that the potential benefits of the performance reporting proposals merit the incremental work that registrants would need to undertake to implement them.

Registrants also had concerns about the complexity of certain performance reporting information and whether clients would even comprehend or use this information. We have

learned that investors want this type of information and can find it useful if it is communicated in a clear and understandable manner.

Document testing of a sample performance report

In conjunction with preparing the amendments to the Instrument, we developed a sample performance report that reflected the account performance reporting proposals. This document was tested on a one-on-one basis with investors, dealers and advisers to obtain reactions on its usefulness, clarity and overall appeal. The report *Canadian Securities Administrators Performance Report Testing* prepared by Allen Research Corporation is or will be available on the websites of CSA jurisdictions (see section 11 of this Notice, Where to find more information).

The research report indicates that the sample performance report was well received by the investors and registrants who participated in the testing. The investors described it as clearly written and offering them some information that they do not currently receive. Many of the investors preferred to have performance information presented using a combination of text and visual tools, such as tables, charts or graphs. Registrants also reacted positively to the sample performance report, but requested some modifications based on the types of clients or investment products that they deal with.

The research report recommends changes to the sample performance report based on the feedback received. After reviewing the research report, we made changes to clarify the information in the document and to better reflect the type of information that investors would find useful and meaningful. The revised sample performance report is included in draft Appendix D of the Policy Statement.

While we do not intend to prescribe a form in the Regulation for presenting performance information, we expect dealers and advisers to present this information in a clear and meaningful manner. This includes a requirement to use a combination of text and tables, charts or graphs. We encourage registrants that are already providing additional performance information to continue to do so.

Further research

In section 4 of this Notice, we discuss our plans for further research on clients' understanding and expectations with respect to account reporting.

3. Summary of the draft amendments to the Instrument

The draft amendments are intended to materially improve investor protection and would:

- enhance the current disclosure of charges in the Regulation related to the operation of an account, and the making, holding and selling of investments

- enhance the current disclosure of the compensation received by a registered firm, particularly relating to charges such as trailing commissions and deferred sales charges, which are not always well understood by investors

- provide guidance in the Policy Statement on inappropriate switch transactions and the resulting compensation received by registrants, which may not be as transparent as other types of charges

- add a requirement to include information on the original cost of securities in the account statement

- add new account performance reporting requirements that would assist investors in determining how their account is performing

A. Disclosure of charges

We propose to enhance the requirements for the disclosure of charges at account opening for all accounts. We propose also to add new requirements for the ongoing disclosure of charges, both before accepting a client's order for a trade in an account where the registrant does not have discretionary authority (non-managed account), and annually for all types of accounts.

Relationship disclosure information

We are proposing in section 14.2 [*relationship disclosure information*] to replace the term *costs* with the term *charges* to avoid confusing the charges associated with the operation of an account or executing transactions with the actual purchase cost of a security.

We are also proposing some clarifications of the expectations for relationship disclosure information that is required to be provided under this section.

Pre-trade transaction charge disclosure

We propose requiring registered firms to provide specific disclosure of the charges a client with a non-managed account would have to pay when purchasing or selling a security prior to the registrant accepting the client's order.

Annual disclosure of charges

We propose requiring registered firms to provide each client with an annual summary of all charges incurred by the client and all the compensation received by the registered firm that relates to the client's account.

In addition, registrants would be required to disclose the nature and amount of compensation received from third parties, such as trailing commissions and referral fees, that were generated as a result of the client's account. Registrants would also have to disclose whether mutual fund holdings could be subject to a deferred sales charge.

Most investors do not currently receive personalized information on certain fees such as trailing commissions, deferred sales charges and referral fees and consequently, may have little understanding of these terms. We acknowledge that some information about these charges must be disclosed in the simplified prospectus for mutual funds. However, research indicates that many investors do not find the prospectus to be an accessible source of information. *Regulation 81-101 respecting Mutual Fund Prospectus Disclosure* contains the requirements to produce and file the Fund Facts document which was created in response to this concern, but it only contains disclosure on mutual fund charges. By providing clients with consolidated annual disclosure of all charges, the proposed requirements should assist in informing investors and raising awareness of how much their investments are actually costing them.

B. Performance reporting

Cost information

We propose requiring registrants to include original cost information for each security position in the account statement. This information should assist investors in assessing how well individual securities are performing by comparing their original cost to their current market value.

Issue for comment

We have considered the option of permitting the use of tax cost (book value) as an alternative to original cost. We invite comments on the benefits and constraints of each approach to cost reporting, in particular as they relate to providing meaningful information to investors and their usefulness as a comparator to market value for assessing performance.

We have also added guidance in the Policy Statement on the determination of market value.

Issue for comment

Is the guidance provided on determining the market value of securities in section 14.14 [*client statements*] of the Policy Statement useful and sufficient? Please indicate if there is additional or different guidance needed. We are particularly interested in your comments on the guidance related to the valuation of exempt or illiquid securities where there are no quoted values available.

Performance reports

We propose adding a new section 14.15 [*performance reports*] which would require firms to provide clients with account performance reporting on an annual basis. The content of the performance reports would be set out in a new section 14.16. This information would be provided as part of, or together with, the account statement.

Issue for comment

We acknowledge that there are unique features to group plans offered by scholarship plan dealers (group scholarship plans). We invite comments on whether the proposed account performance reporting requirements should apply to accounts invested in group scholarship plans or what other types of performance reporting would be useful to clients of group scholarship plans in lieu of the proposals outlined in the Regulation.

The account performance reporting proposal includes the following components:

(a) Net amount invested

This is the actual dollars invested by the client and allows clients to assess how well the account has performed by comparing their investment to the market value of the account.

(b) Change in value

Clients would be provided with the change in the value of their account over the past 12- month period and also since the inception of the account. For example, the change in the value of the account since inception is the difference between actual dollars invested in the account and the market value of the account. It tells investors how much money they have actually made or lost in dollar terms.

Registered firms would be permitted to break out the change in value figure into more detail as described in the Policy Statement. However, the change in value would not be required to include realized capital gains and losses, unless the realized gains have been reinvested into the account. Clients should continue to receive this information separately for tax reporting purposes.

(c) Percentage returns

Dealers and advisers would be required to provide clients with annualized compound percentage returns of their account for specified time periods.

(d) Use of benchmarks

As part of the relationship disclosure information delivered to clients at account opening under section 14.2 [*relationship disclosure information*], registered firms would be required to provide each client with a general description of benchmarks, the factors that should be considered when using them and whether the firm offers any options for benchmark reporting to clients. This information is intended to make investors generally aware of benchmarks and their uses and limitations, and to ensure that investors are aware of any benchmark information that the firm makes available.

In addition, registered firms would be permitted to provide benchmark return information as part of their account performance reporting in circumstances where the firm and the client have agreed in writing to the use of benchmarks [proposed section 14.17 *benchmark information*].

We do not propose to require any further delivery of benchmark information in the Regulation due to the mixed feedback we received during the document testing of the sample performance report. As part of that testing, we explored whether the use of three prescribed and broad based benchmarks would be useful to investors. While some investors understood and wanted this information, the research report indicated that the use of these benchmarks was not well understood by most of the investors. Further, many investors had difficulty comparing the benchmarks to their own account, or determining whether the benchmarks were relevant for comparison purposes.

We recognize that the use of benchmark information has its challenges. Guidance on the use of benchmarks that are meaningful and not misleading has been added to the Policy Statement. In general, a meaningful and relevant benchmark should assist an investor in measuring:

- the value added to an investor's account by a particular dealer or adviser in exchange for the fees paid by the investor

- the relative rewards and advantages of investing in the manner chosen as opposed to a passive alternative

- whether the investor's performance return goals are realistic compared to the market's returns

4. Continuing work on what securities should be included in reporting

In the June 25, 2010 Notice of and request for comment on draft amendments to Regulation 31-103, we sought feedback on eight questions related to what securities should be reported in account statements and related issues. We thank everyone who submitted comments.

We have not proposed any changes to section 14.14 [*client statements*] of the Regulation in this publication related to this feedback.

Additional research

We have determined that more work needs to be done on these issues. We intend to:

- conduct further research with investors on their understanding and expectations about reporting on their security holdings

- consult further with industry participants to better understand the risks, benefits and constraints of reporting on clients' security holdings and the manner in which they could be disclosed, such as in the account statement or in another document. For example, in the context of securities sold by exempt market dealers, the type of reporting

required may depend on whether the client's securities are held on the books of the registrant or the issuer

- revisit comments and feedback already received

After we have the benefit of this information, we may publish additional proposals for comment. In any event, we will communicate the outcome of this work.

5. Transition

Some registered dealers and advisers would require time to adjust their reporting practices in order to meet the requirements for disclosure of charges and performance reporting if the amendments are adopted. In addition, we recognize that certain information required to be reported under the draft amendments is not currently available. Therefore, we have proposed the following transitional provisions:

- information will only be required to be reported on a go-forward basis so that firms will not be required to retrieve data for past periods unless it is already available

- a phased introduction period of two years following implementation of the amendments for most of the new requirements

6. Impact on SRO members

We worked with both SROs to harmonize the Regulation and SRO rules relating to disclosure of charges and performance reporting. To the extent that the SRO rules differ materially from the Regulation if the amendments are adopted, each SRO will propose additional rule amendments to its cost disclosure and performance reporting requirements. These will be subject to final approval by applicable CSA members. Subject to approval, subsections 14.2(2) to (6) [*relationship disclosure information*] and sections 14.15 [*performance reports*], 14.16 [*content of performance reports*] and 14.17 [*benchmark information*] would not apply where the SROs have rules providing for substantially similar requirements.

On January 7, 2011, IIROC published for a third comment period draft amendments to its Dealer Member Rules to implement the core principles of CRM (IIROC Notice 11-0005). The comment period ended on March 8, 2011, and the draft amendments are currently under review.

The MFDA has also published its draft amendments relating to CRM, which were approved by its members at its December 1, 2010 annual general meeting. The amendments will come into force subject to the prescribed transition periods.

7. Alternatives considered

We did not consider alternatives to the draft amendments.

8. Anticipated costs and benefits

The anticipated investor protection benefits of the draft amendments are discussed in section 1 of this Notice. We think the potential benefits to investors outweigh the costs to registered dealers and advisers of providing additional disclosure to their clients.

9. Unpublished materials

We have not relied on any significant unpublished study, report, or other written materials in preparing the draft amendments.

10. Request for comments

We welcome your feedback on the draft amendments. We need to continue our open dialogue with all stakeholders if we are to achieve our regulatory objectives while balancing the interests of investors and registrants.

All comments will be posted on the Ontario Securities Commission website at www.osc.gov.on.ca and on the Autorité des marchés financiers website at www.lautorite.qc.ca.

All comments will be made publicly available.

We cannot keep submissions confidential because securities legislation in certain provinces requires publication of a summary of the written comments received during the comment period. Some of your personal information, such as your e-mail and residential or business address, may appear on the websites. It is important that you state on whose behalf you are making the submission.

Thank you in advance for your comments.

Deadline for comments

Your comments must be submitted in writing by September 23, 2011.

Send your comments electronically in Word, Windows format.

Where to send your comments

Please address your comments to all CSA members, as follows:

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

Please send your comments **only** to the addresses below. Your comments will be forwarded to the remaining CSA member jurisdictions.

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11. Where to find more information

The draft amendments and the research reports are or will be available on websites of CSA members, including:

www.lautorite.qc.ca
www.albertasecurities.com
www.bcsc.bc.ca
www.msc.gov.mb.ca
www.gov.ns.ca/nssc
www.nbsc-cvmnb.ca
www.sfsc.gov.sk.ca

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