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September 8, 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 Sasktachewan

c/o Josée Turcotte, Secretary
Ontario Securities Commission
20 Queen St. W., 22nd Floor
Toronto, ON M5H 3S8

and

c/o Ms Anne-Marie Beaudoin, Corporate Secretary
Autorité des marchés financiers
800 rue de Square-Victoria, 22e étage
C.P. 246, tour de las Bourse
Montréal, Québec H4Z 1G3

Re: CSA Consultation Paper 33-404

Please find enclosed our comments made in response to CSA Consultation Paper 33-404. The comments are solely in our personal capacity.

Please feel free to follow-up with either of us. Ed Waitzer can be reached at ewaitzer@stikeman.com. Keith Ambachtsheer can be reached at keith@kpa-advisory.com.

Yours truly,

Edward J. Waitzer

Keith Ambachtsheer

Enclosure

SUBMISSION TO THE CANADIAN SECURITIES ADMINISTRATORS

Date: September 9, 2016

To: The Canadian Securities Administrators

From: Keith Ambachtsheer and Ed Waitzer

RE: CSA CONSULTATION PAPER 33-404 – PROPOSALS TO ENHANCE THE OBLIGATIONS OF ADVISORS, DEALERS, AND REPRESENTATIVES TOWARDS THEIR CLIENTS

Thank you for the opportunity to submit our views on this important topic.

We see the CSA's initiative as requesting guidance to create and implement measures that will achieve better financial outcomes for the clients of Canada's retail investment advice and management industry.

As two individuals who have studied this question from both academic and professional perspectives for multiple decades, we believe we are well-placed to respond and contribute to the CSA's request.[i]

A Time to Act

In 1994, the Ontario Securities Commission asked Commissioner Stromberg to undertake a review of regulatory issues facing the then rapidly growing investment fund industry. Her report, released in January 1995, highlighted inherent conflicts of interest with respect to the structuring and management of investment funds and the distribution of securities generally – all resulting in the interests of clients not being placed first. She also noted the inadequacy of the training and proficiency of many of those who sell and manage investment funds. Her proposals addressed these conflicts of interests and proficiency gaps.

With the passage of over twenty years, the significance of the issues highlighted in the Stromberg report now have systemic implications. For one, a strong financial services sector depends on public trust. This has been seriously eroded and is unlikely to be restored (or a sound regulatory framework built) unless investors are entitled to expect that the financial professionals they rely upon are proficient and will be held accountable to a uniform best interest standard. As importantly, the lack of workplace pension coverage for the majority of Canadian workers, coupled with the ongoing transfer of wealth from savers to the financial sector through high investment fees, have become challenges to the adequacy of retirement income savings. The time has come to act, rather than continue to kick the can down the road.

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[i] Separately and together, we have published a series of articles and studies on the question over time. The most recent (a copy of which is attached) is our article "Our investment advisers' moral compasses are still being aligned" in the August 16, 2016 edition of the Globe & Mail. Bios can be found appended to this submission.

Poor Financial Outcomes

Simple logic predicts that when retail investors are advised by people with conflicting interests and limited competencies, poor financial outcomes will result. There is considerable evidence that this is in fact the case. For example, in a recent Financial Analysts Journal article, Jack Bogle reports a -4%/yr. average underperformance relative to the market for U.S. mutual fund investors for the 15-year period ending June 30, 2013.[ii] A new paper by researchers from the University of Chicago, Northwestern University, and Western University sheds important light on the 'value-of-financial-advice' question in a Canadian context.[iii] Their study compared the investment behavior and results of a large sample of Canadian mutual fund investors and those of the people who advise them. The researchers found that while conflicts of interest do appear to impact the behavior of some advisers, there is a bigger problem.

They found that in most cases, there was a strong correlation between how advisers advised their clients to invest, and how they invested themselves. However, their own investment results were, on average, worse than their clients'. While their clients underperformed their passive benchmarks by an average -3%/yr., the advisers' own portfolios underperformed by an average -4%/yr. These findings led the researchers to conclude that in too many cases, advisers are drawn into the industry with the misguided strong belief that the combination of high-fee funds and high turnover will improve investment performance.[iv]

Better Financial Outcomes for Clients

These new findings confirm yet again the wisdom of Commissioner Stromberg's 1995 dual recommendations of establishing a clear 'best interest' fiduciary standard, as well as a clear competency standard for individuals providing investment advice in Canada.

As noted by one of us in a related op-ed (attached),[v] Canada takes justifiable pride in our financial institutions and infrastructure. In doing so, we can ill afford to gloss over the nature of customer relationships or be perceived to lag other jurisdictions in our efforts to ensure fair dealing in financial markets. The stakes are too high (and are growing).

Attachments

[ii] See Bogle (2014), "The Arithmetic of 'All-In' Investment Expenses", FAJ, Jan-Feb.

[iii] Linnainmaa, Melzer, and Previtera (2015), "Costly Financial Advice: Conflicts of Interest, or Misguided Investment Beliefs?", Working Paper. The study was based on a sample of some 500K Canadian mutual fund investors with collective assets of $20B, being advised by some 5K investment advisors.

[iv] We noted that the client investment performance results reported in the new LMP (2015) study are consistent with those of prior studies of mutual fund performance performed over the course of the last 20 years. However, as far as we know, this is the first study to document that the average investment performance of the advisors' own portfolios were even worse than those of their clients'. The study's general findings are also consistent with a personal experience of one of the authors of this submission from some time ago. A 65-year-old just-retired friend requested an assessment of her $300K retirement savings portfolio. It was made up of five high-fee equity mutual funds with no obvious connection to her age, risk tolerance, or her approaching need for supplemental retirement income. Her 'advisor' was shocked when she informed him that she was closing the account and moving to a lower-cost solution more suitable to her circumstances.

[v] See "Make advisors work for investors" in the February 14, 2011 edition of the National Post.

APPENDIX - BIOS

Keith Ambachtsheer *was named 'Top 30 Difference-Maker' by P&I, the 'Globe's #1 Knowledge Broker in Institutional Investing' and in the 'Top 10 Influential Academic in Institutional Investing' by aiCIO, in the 'Top Pension 40' by II, 'Outstanding Industry Contributor' by IPE, the Lilywhite Award winner by EBRI, and the 'Professional Excellence' and 'James Vertin' Awards winner by the CFA Institute.*

He is Adjunct Professor of Finance, Rotman School of Management, University of Toronto, and Director Emeritus of its International Centre for Pension Management. He is a member of the Melbourne-Mercer Global Pension Index Advisory Council, the CFA Institute's Future of Finance Advisory Council, and the Georgetown University Center for Retirement Initiatives Scholars Council.

Edward Waitzer *served as Chair of the Ontario Securities Commission from 1993 to 1996. He holds the Jarislowsky Dimma Mooney Chair in Corporate Governance at Osgoode Hall Law School and the Schulich School of Business (York University) and is a senior partner (and former Chair) of Stikeman Elliott LLP.*

Financial Post

News

Make advisors work for investors

Edward Waitzer, Financial Post · Tuesday, Feb. 15, 2011

In January 2004, the Ontario Securities Commission released a concept paper advocating a "fair dealing model." The paper acknowledged that the regulatory regime -- regulating dealers and their representatives through the products they sell -- was based on the outdated assumption that transaction execution is the primary reason people seek financial services. Recognizing that most customers are seeking advice, the concept paper proposed changing the regulatory framework to focus on the advisory relationship.

Financial professionals and salespersons in Canada are allowed to call themselves advisors, irrespective of their professional designation. Few, however, are compensated directly for their advice. Instead, they are paid commissions to sell specific products. Addressing the conflicts of interest that result from commission-based compensation, the paper proposed that retail clients should be entitled to rely on objective advice that is in their best interest and, when there are conflicts of interest, they should be clearly disclosed so that the client can understand the conflicts and how they may affect the advice given.

In September 2004, the proposal was swept into a broader project of the Canadian Securities Administrators (CSA) and rebranded as the "client relationship model." Last month, the Investment Industry Regulatory Organization of Canada (IIROC) published its proposed reforms to establish requirements for the client relationship model. They specifically avoid imposing a duty on firms and their representatives to act in the best interest of clients, focussing instead on improving compliance with the existing "suitability" standard and improving disclosure with respect to conflicts of interest and performance reporting. IIROC noted that part of what influenced its thinking was an effort to harmonize with existing and proposed CSA standards (and other standards applicable to firms not under its jurisdiction).

To understand the difference between a "suitability" and "best-interest" standard, think of a student seeking advice at an electronics store about her need for a laptop. The salesperson recommends a highly priced unit with an expensive extended warranty -- all designed to generate the highest commission. The laptop is suitable--it will satisfy the student's needs. It clearly isn't the best solution and a disclosure obligation isn't likely to stand in the way of a motivated salesperson. If the salesperson had been bound by a "best-interest" standard, he would recommend a simpler, more reliable and affordable unit.

In the U.S., brokers and investment advisors are subject to different standards when providing investment advice. Many investors are unaware of these differences or their legal implications or find them confusing. In the wake of the global financial crisis, the Dodd -Frank Act required the Securities and Exchange Commission (SEC) to evaluate the effectiveness of existing legal or regulatory standards of care for providing personalized investment advice to retail customers. Five months later and with the benefit of over 3,500 comment letters as well as a survey conducted by the CFA Institute (which already requires both a suitability and best-interest standard of its members in order to use the Chartered Financial Analyst professional designation) SEC staff released its analysis and recommendations. It has proposed a uniform standard of conduct for all brokers, dealers and investment advisors providing personalized investment advice about securities to retail customers to act in the best interest of the customer.

The SEC staff study acknowledges that working through the details of such a standard so as to ensure it is practicable and cost effective will be complex. It does not propose a strict fiduciary duty, nor does it suggest rules to try to eliminate conflicts.

The U.K. Financial Services Authority (FSA) recently banned commissions for advised sales of retail investments and released proposals which would require advisors to explain why a product is better than a cheaper alternative. This and other more intrusive proposals are based on the FSA's realization that there are "fundamental reasons why financial services markets do not always work well for consumers."

The contrast in the direction, speed and intensity of regulatory reform between Canada and other major developed markets raises a number of questions and suggestions. Why did the OSC start down the path of a "best-interest" standard in 2004 and, while others (including the U.K., Europe and Australia) have caught up, we appear to have fallen back to where we started -- disclosure requirements and a relatively static "suitability" standard? To what extent is this a function of a fragmented regulatory framework suffering from bureaucratic inertia (and an industry suffering from regulatory fatigue)? What accountability mechanisms are required to motivate a more focussed and intense effort?

Why is it that Canadian regulators have shied away from proposing a "best-interest" standard? As one commentator to the SEC staff's study noted, "If the product sold is that of advice, then that advice should be in the best interest of the client. Anything else is fraud, because the seller is delivering a service different from what the consumer thinks he or she is buying." Many argue that it's the buyer's responsibility to do due diligence and shop around for the best price. But should caveat emptor apply when buyers think they are hiring a professional to do the shopping?

There may be light at the end of this tunnel. Hopefully, the robust regulatory reform efforts underway elsewhere will inform and impose some discipline on our own. The OSC has a new chair. It recently established a highly credible Investor Advisory Panel, which has added this issue to its list of initiatives. FAIR Canada, the Hennick Centre for Business and Law, and the Toronto CFA Society are convening a second annual symposium on the subject next week. Finance Minister Jim Flaherty has demonstrated genuine interest in investor protection -- most recently supporting a national strategy to strengthen financial literacy.

Canada takes justifiable pride in its financial institutions and infrastructure. In doing so we can ill afford to gloss over the nature of customer relationships or be perceived to lag other markets in our efforts to ensure fair dealing in financial markets.

- Edward Waitzer is a professor and director of the Hennick Centre for Business and Law at York University and a former chair of the Ontario Securities Commission.

AMBACHTSHEER and WAITZER

Our investment advisers' moral compasses are still being aligned

KEITH AMBACHTSHEER and ED WAITZER

Contributed to The Globe and Mail

Published Friday, Aug. 19, 2016 5:00AM EDT

Keith Ambachtsheer is director emeritus of the International Centre for Pension Management at the Rotman School of Management, University of Toronto, and president of KPA Advisory Services.

Edward J. Waitzer is Jarislowsky Dimma Mooney chair and director of the Hennick Centre for Business and Law, Osgoode Hall Law School and Schulich School of Business, and senior partner at Stikeman Elliott LLP.

In 1994, the Ontario Securities Commission asked one of its commissioners to undertake a review of regulatory issues facing what was then a rapidly growing investment fund industry. Commissioner Glorianne Stromberg's report, released in January, 1995, highlighted inherent conflicts of interest with respect to the structuring and management of investment funds and the distribution of securities generally – all resulting in the interests of consumers not being placed first. She also noted the inadequacy of the training and proficiency of many of those who sell and manage investment funds. Her proposals addressed these conflicts of interests and proficiency gaps.

More than 20 years later, the Canadian Securities Administrators is still studying these issues. Many in the industry continue to argue that it is the client's responsibility to do their homework. Should *caveat emptor* apply when buyers think they are hiring a professional to help them do the shopping?

With the passage of time, the significance of the issues highlighted in Ms. Stromberg's report now have systemic implications. For one, a strong financial-services sector depends on public trust. This has been seriously eroded and is unlikely to be restored (or a sound regulatory framework built) unless investors are entitled to expect that the financial professionals they rely upon are proficient and will be held accountable to a uniform best-interest standard. As importantly, the lack of workplace pension coverage for the majority of Canadian workers, coupled with the ongoing transfer of wealth from savers to the financial sector through high investment fees, have become challenges to the adequacy of retirement income savings. We continue to kick the can down the road.

The notion that financial professionals must act in the best interests of their clients and make full disclosure, particularly regarding conflicts of interest, is long overdue. The need for such core principles have been recognized in most other mature market economies. The suggestion by some Canadian securities regulators is that incremental rules, in the absence of strong foundational principles, may be sufficient. The result, if this approach is taken, will defer practical solutions and raise expectations, which will be disappointed.

We must also look beyond principles that seek to provide a strong moral compass for the industry and focus on ensuring the proficiency of investment “professionals.” If accountants, actuaries and lawyers need to go through rigorous certification processes to practise their profession, why not investment advisers and managers? The stakes, for clients, are often higher, as a recent study concluded.

The study compared the investment behaviour and results of a large sample of Canadian mutual-fund investors with those of the investment advisers who serve them. The researchers found that while conflicts of interest impact the behaviour of some advisers, there is a bigger problem. In most cases, there was a strong correlation between how advisers advised their clients and how they invested themselves. In fact, on average, their investment results were worse than those of their clients. The researchers concluded that, in too many cases, advisers are drawn into the industry with the, misguided, strong belief that the combination of high-fee funds and high turnover will improve performance. This suggests that most investment advisers know no more about successful investing than their clients do.

Finally, it should not be surprising that countries with the strongest best-interest standards for financial advisers also have the strongest rules regarding workplace pension-plan participation. While fiduciary principles-driven funds will easily generate twice the pension per dollar of contribution than the average mutual-fund option, more than three-quarters of Canadian private-sector workers do not participate in a pension plan other than the Canada Pension Plan. The recent agreement to enhance CPP benefits has moved Canada’s retirement savings yardstick in the right direction, but will not fully bridge this looming retirement savings gap. Canada’s financial-services regulators and industry should play a constructive role by raising the bar on fiduciary conduct and designing and offering cost-effective workplace pension plans for 21st-century realities.