SIPA
SMALL INVESTOR PROTECTION ASSOCIATION

A Voice for Small Investors

February 25, 2011

To: Richard J. Corner ,Vice President, Member Regulation Policy - e-mail to rcorner@iiroc.ca
Angie F. Foggia ,Policy Counsel, Member Regulation Policy - e-mail to afoggia@iiroc.ca
Investor Industry Regulator of Canada;

Re: Proposals to implement the core principles of the Client Relationship Model (CRM)

We provide herewith our comments on proposals related to the Client Relationship Model. Although we can see that a great deal of effort was expended on the review of this issue we do believe that some of the principles of the fair dealing model seem to have been diluted.

There are many features and ideas that are good however when we consider the fundamentals of what investors need there seem to be some continuing weaknesses in the CRM approach. It is difficult trying to tweak something that is fundamentally flawed and sometimes it becomes necessary to introduce what at first my seem to be radical change.

We believe the Client Relationship must be disclosed in a short document in similar fashion to the POS Product Disclosure document. That is it should be mandatory to provide it at the Point of Engagement and prior to the completion of the NAAF.

There are some issues we face in Canada which make it difficult for small investors. We have a myriad of regulators and jurisdictions, weaknesses in our legislation, and failures of our regulatory and justice systems to recognize the impact on the victims or the extent of the wrongdoing and fraud currently existing in our regulated investment system.

Of course there is the fraud and wrongdoing that occurs without the regulated industry but this may be less significant that that which occurs within. We are not aware of any efforts made to quantify the extent of these issues but various estimates are in the tens of billions per annum.

The recent financial market meltdown has revealed many longstanding wrongdoing and frauds within and without the regulated system. It has also served to raise awareness in a way that critics of the investment industry regulator complex have been unable to accomplish in the last quarter century.

In our work with SIPA we have encountered a whole new awareness that did not exist a few short years ago. When people lose a significant amount of money they become acutely aware of the issues that led to their loss. Although they may not be fully aware of the specific reasons, they are aware that something is terribly wrong when they had been led to believe they were in good hands and could trust a "well regulated industry" to look after their investments.

Now there is a growing realization that investors have been too complacent and trusting and not aware of the lack of responsibility and accountability practiced by many in the investment industry regardless of the best efforts of the regulator. It seems to many observers that there is an industry culture that is highly reward motivated but considers the rules and regulations only guidelines. They are resistant to regulation and develop products and practices to circumvent the regulations and the regulators.

A few examples of these abusive practices:

- KYCs prepared by registrants without Client understanding and the modification of KYCs to match the account contents without Client consent or knowledge. We encounter situations where small investors have issues and when they ask for a copy of their KYC it is not factual and the signature is not theirs.
- The selling of unsuitable products that carry higher commissions to Clients who do not understand the products or the related risks. Principle Protected Notes, Business Income Trusts and Asset Backed Commercial paper are a few prominent examples.
- The leveraging of Client accounts to increase Assets Under Management to generate greater earnings for the Advisor without regard to the increased risk for the investor and the often disastrous results for Clients.
- Failure to provide meaningful Client statements so that Clients remain unaware there are issues until it is too late to mitigate substantial loss. The practice of reporting book value versus market value often misleads the investors as losing investments are sold and book value reduced so as to make the total comparison look better. A typical comment by small investors is *"My Advisor tells me I am making money, and my statement shows I am making money (book value ids less than market value) but I have less money now than I had X years ago and I have taken nothing out."* Also many clients who are placed in margin are unable to interpret their statement and believe their account has value because of the amount of securities held. Some small investors have had almost zero equity but still believed they had not lost their money. They do not understand the concept and the statements are not clear.
- Discretionary action by "Advisors" when the account is not a discretionary account. When the "Advisor" tells a small investors they needn't worry because the Advisor will look after their account, the Client believes it is a discretionary and the Advisor has fiduciary responsibility. They are not aware there are specific forms to be competed for a discretionary or managed account. This practice seems at best to be condoned if not encouraged.

We believe it is difficult for well educated persons or sophisticated investors to realize how confusing investment can be for anyone who is busy with family and career and has not had any financial training to understand the proliferation of various types of products including mutual funds, various types of shares and bonds, and structured products which are often not even understood by the "Advisors" selling these products.

Now we are seeing a new breed of "Financial Advisor" seeking professional qualifications and providing a new approach by being paid for advice given and receiving no commissions. It is not easy for these pioneers because many small investors still believe they are getting free advice

when they are dealing with those who are really commissioned sales people without responsibility for Clients best interests, and at the same time believe the industry has a fiduciary responsibility. They are not aware that in Canada it is a Buyer Beware investment regime. The regulators should make this clear to investors if they are unwilling or unable to hold the industry accountable with fiduciary responsibility.

At the same time we see initiatives by the investment industry regulator complex intent on evading the responsibility that should be inherent with the provision of investment advice. Whether it is promoting financial literacy, providing deemed disclosure on websites (not all small investors have computers), providing disclosure not understood by most Canadians, trending from defined benefit pension plans to defined contribution plans to download the investment responsibility onto pensioners, regulatory failure to seek a mandate to order restitution when regulators have found fraud and wrongdoing, failure to require disclosure of the true responsibility (or lack of) of registrants, or many other initiatives or failure to act.

All these factors must be taken into account when formulating a Client Relationship Model to avoid the possibility of perpetuating the illusion to create investor perceptions removed from reality.

In our opinion the investment industry is based on transactions each of which includes Product, a Buyer and a Seller. It is acknowledged that we are in a Buyer Beware investment environment and initiatives are required to help level the playing field. The commendable financial literacy initiative will not in itself resolve the problem that investors face. Canadians are pre-occupied with careers and family and place their trust in an advisor when looking to invest.

Often Canadians turn to family and friends to recommend an "Advisor". However there is a critical issue to deal with here. Investors must determine whether the individual is an unregulated fraudster or not. It is possible for investors to check with the regulators to determine whether the "Advisor" is legitimate or not. This should help investors avoid direct unregulated fraud. But they do not. They trust that all is well. Bernie Madoff in the States and Earl Jones in Canada are two recent examples that the current system does not protect investors who continue to trust.

Another fundamental issue is the misleading marketing and representation used by the industry that misleads Canadian investors. Most Canadians believe that "Advisors" have fiduciary duty which they should have. However sellers of product including mutual funds and segregated funds often masquerade as Advisors when they really are sales representatives. This is made possible by the regulators allowing the industry to use titles that convey a false impression to investors.

The first thrust of the financial literacy program should be to make investors aware that it is a Buyer Beware industry and that the people selling products are in fact sales people. It does not help if the regulations show that the sales people are sales representatives or dealer representatives if the regulators permit false and misleading advertising when the industry calls these sales people "investment advisor", "financial consultant" or some other fancy title and

allow the use of the title Vice President to recognize the better sales people. How can investors differentiate between a qualified Financial Advisor and a super salesman masquerading as a "Financial Advisor". It is unfair and unreasonable to expect the average Canadian to be responsible for determining the difference when they expect the regulators will ensure that Financial Advisors are qualified and competent in order to be registered.

In order to help advance investor protection as the regulators claim is important, we propose that the Client Relationship Model should improve disclosure that will help investors to do their due diligence that is so important in a Caveat Emptor relationship. The investment industry consists of transactions comprising a Product, a Buyer and a Seller and disclosure is (or should be) required:

1. Product disclosure may be provide by a prospectus which may or may not be delivered to the investor. The initiative to introduce Point of Sale Disclosure will provide effective disclosure, at least for mutual funds (but should apply to all products) which represent the bulk of Canadians' investments.
2. The Buyer. Buyer disclosure is provided when the Client completes a New Account Application Form or a Know your Client Form. A copy of this should be signed by the Client and a copy given to the Client so that changes may be made when there are significant events in the Clients life. KYCs created to reflect Client holding prior to regulatory checks prevent regulators from doing their job. Occasional spot checks are required to ensure good supervision.
3. The Seller. The Seller is often represented by a sales representative commonly called an "Advisor" in whom clients place their trust. It seems only fair if the Client is to assume any responsibility for his account that there should be a Point of Engagement Registrant Disclosure that would disclose the "Advisor's" qualifications and registration. The "Advisor's" education, qualifications, certifications, work experience, method of remuneration, and registration would be revealed to Clients along with any disciplinary history. The registration details would include whether the "Advisor" is an Adviser (Most Canadians have no idea that there is a difference between and Adviser and an Advisor), Manager or sales representative as well as the products the registrant is qualified to sell. This POE Registrant Disclosure would also indicate the Employer with contact details for management and compliance as well as any firm disciplinary history (specifically failure to supervise and number of registrant disciplines).

The Registrant Disclosure should be mandatory and provided prior to engagement and one of the requirements prior to opening an account. The requirement for a POE Registrant Disclosure would enable investors to avoid in large part dealing with an unregulated fraudster, and enable them to weed out the bad Advisors. Of course the regulators would have to ensure that the firms were in fact properly supervising to ensure the Registrant Disclosure is factual.

Nevertheless, we see some positive statements in the proposed Client Relationship Model, and offer the following more specific comment annotated on the summary.

The proposed Rules and amendments are summarized as follows:

(a) Relationship disclosure for retail client accounts

It should be mandatory that a Point of Engagement Registrant Disclosure be provided to the Client prior to the NAAF being signed. The Client should have a 48 hour rescission period from receipt of the POE Advisor Disclosure.

IIROC is proposing that every Dealer Member will provide its retail clients with the following information regarding the relationship they are entering into with the client:

a description of the types of products and services offered by the Dealer Member;

This should include specific products excepted such as bonds & shares when only mutual funds can be sold.

a description of the account relationship to which the client has consented;

This should clearly indicate whether it is fiduciary or not, and discretionary or not, and how the registrant is remunerated indicated as a percentage

where applicable, a description of the process used by the Dealer Member to assess investment suitability, including a description of the process used to assess the client's "know your client" information, a statement as to when account suitability will be reviewed and an indication whether or not the Dealer Member will review suitability in other situations, including market fluctuations;

Suitability is an issue which deserves standard definitions rather than individual assessments -

Example: A senior executive explained in writing why each of 27 positions owned by a senior were "suitable" even though 70% of the senior's account was lost (this was not in a down market)

a statement indicating material Dealer Member and adviser conflicts of interest and stating that future material conflict of interest situations, where not resolved, will be disclosed to the client as they arise;

There should be disclosure of the difference between an Adviser and an Advisor. We believe it is misleading at best to allow Advisor or other titles to registered sales persons that mislead investors. The use of Vice President to reward sales persons is also deceptive and should not be allowed.

a description of all fees, charges and costs associated with operating the account and in making or holding investments in the account; and

All fees. charges and costs should be reported on each client statement and not be relegated to a general description. Total fees, changes and costs should be indicated in dollars and as a percentage so that investors know how much the "Advisor" service is costing.

a description of account reporting the client will receive, including a statement identifying when account statements and trade confirmations will be sent to the client and a description of the Dealer Member's obligations to provide account performance information and a statement indicating whether or not percentage return information will be sent.

It should be mandatory that account performance be provided on each client statement indicating the annualized rate of return and comparing it to an appropriate benchmark. This will enable investors to compare their account performance to the cost of service..

The obligations of Dealer Members to provide certain specific disclosures regarding suitability will vary for order-execution service accounts and managed accounts, in that there is no suitability obligation regarding order-execution service accounts and managed accounts must be monitored and supervised according to the specific, more rigorous standards imposed under Rules 1300 and 2500.

Suitability is one of the important issues for small investors and there should be a mandatory standardized approach for accounts other than order-execution. It should be clear that order-execution accounts refer to discount brokers and NOT to accounts where Advisors offer advice although registered as dealers' representatives

IIROC is not proposing to mandate the format of the disclosures, but will require that the information be:

1 *Provided to the client in writing at the time of account opening;*

2 *Written in plain language; and*

3 *Included in a document entitled "Relationship Disclosure" (This is good)*

4 The relationship disclosure should be mandated with a POE Registrant Disclosure form that
5 indicates the Advisors registration details, education, qualifications, experience, number of clients,
6 AUM, size of accounts handled, disciplinary record as well as whether he is qualified to operate a
7 managed or discretionary account and his obligations (provide advice, only execute trades, provide
8 Investment policy statement, provide statements, etc. It should also provide firm details, regulators
9 and contact, and disciplinary history.

Dealer Members are obligated to provide some of the relationship disclosure information under the current Rules. The proposed Rule allows for information already provided to clients to essentially be incorporated by reference as long as the relationship disclosure contains a description of this information and the client is specifically referred to the other documents.

Deemed disclosure or referral to other sources is not sufficient. It should be included in the Disclosure document at Point of Engagement. This POE disclosure document and the KYC should be two mandated documents for registrants. This would differentiate registered Advisors from the ordinary unregistered fraudster. Currently a small investor sees little difference between the legitimate registrant and the Ponzi scammer. It would be in the interests of investors and registrants to make a difference and publicize it. The Registrant disclosure should be similar in principle to the POS product disclosure.

Amendments have been made to the previous IIROC proposals published for public comment in April, 2009 to clarify that client acknowledgement must be obtained when either a relationship disclosure or "know your client" document is provided to the client.

This is good but it should be clear that both a Registrant Disclosure and a know your client are mandatory at Point of Engagement and should be signed and dated by both parties with a copy given to the Client

Conflicts management / disclosure

Rules relating to the management of specific conflicts of interest are already in place. To supplement these existing requirements, IIROC is proposing to adopt a general rule to require that all material conflict situations between the Approved Person and the client and between the Dealer Member and the client be addressed by either: avoiding the conflict, disclosing the conflict or otherwise controlling the conflict of interest situation.

In the latter case it should also be disclosed with what is being done to control the conflict or protect the client from being impacted.

Amendments have been made to the previous IIROC proposals published in April, 2009 to clarify the application of the general conflicts management / disclosure standard as it relates to material conflicts of interest between the Approved Person and the client and between the Dealer Member and the client. This has been accomplished by creating separate Rules setting out the obligations of the Approved Person and the Dealer Member, respectively, to address conflicts of interest. The revised wording recognizes that Dealer Members are more likely to have to deal with scenarios in which a Dealer Member must balance the competing interests of two or more of its clients.

the Dealer Member should be held accountable for ensuring all disclosures are provided as they should have direct fiduciary obligations to the clients with responsibility for supervision. Failure to supervise is one of the issues that results in many investors losing their savings. As a minimum, when regulators determine the firm failed to supervise they should be empowered to order restitution for those investors losing due to registrant fraud or wrongdoing that should have been discovered with proper supervision.

(c) Account suitability for retail clients

In addition to the current suitability requirement for trades accepted and recommendations made on retail client accounts, IIROC is proposing that an account suitability review must be performed when certain "trigger" events occur (i.e., transfers/deposits into an account, material change in client circumstances, change in the account representative). (This is good) *It is currently an industry best practice to perform suitability assessments on a periodic basis irrespective of the "trigger" events.*

IIROC is also proposing to clarify how suitability assessment reviews are to be performed. Specifically, proposed amended rules 1300.1(p) through (r) make it clear that all suitability assessment reviews must be performed by taking into consideration the client's "investment objectives and time horizon" and the "account's current investment portfolio composition and risk level."

Best practices or recommended guidelines seem not to help. Mandatory requirements with robust enforcement are necessary. Current investment portfolio composition may not be reliable if the KYC is faulty or the composition does not reflect the investor's needs. Care must be taken to ensure that the client's current details are properly recorded and that suitability has been properly determined within predetermined definitions to an industry standard.

IIROC staff is examining the possibility of introducing further changes to the suitability Rule, in addition to the amendments noted above. Some of these may include consequential amendments to conform the suitability requirements contained in Rule 1300 to the new relationship disclosure requirements. In particular, the proposed relationship disclosure requirements will require the Dealer Member to advise the client that he or she will be provided with a copy of the "know your client" information collected at account opening and when there are material changes to this information. (This is good) *The proposed amendments may also lead to changes in the supervisory requirements under Rule 2500.*

Wording amendments have been made to the previous IIROC proposals published in April, 2009 regarding taking into consideration the client's investment time horizon and the account's current investment portfolio when performing suitability assessment reviews.

As a separate initiative, IIROC staff is republishing for comment guidance to Dealer Members and Registered Representatives on regulatory expectations for meeting their suitability requirements. The current version of this draft guidance, along with a consolidated response to the public comments received on the previous draft, is included as Attachment G.

I can only say that Guidance may not be sufficient for important issues. Mandatory requirements for cornerstone requirements like KYC, POE agency disclosure, and POS product disclosure are required

(d) Account performance reporting for retail clients

In developing the proposed Rules on performance reporting, issues regarding security position cost disclosure, account activity disclosure and account percentage return disclosure were considered.

(i) Security position cost disclosure

IIROC is proposing to mandate that security position cost information be provided to all retail clients at least quarterly. When the proposed Rules were published for comment in February, 2008, input was requested as to the preference to require the disclosure of original cost or tax cost. No clear consensus was reached on this point. However, as we believe original cost provides the most useful information for the purpose of account performance, we have mandated in the proposed amendments that original cost be disclosed. (This is good)

(ii) Account activity disclosure

IIROC is proposing to mandate that account activity information be provided to all retail clients on at least an quarterly basis. This reporting would require disclosure of the cumulative realized and unrealized capital gains on the client's account. (This is good)

(iii) Account percentage return disclosure

IIROC is proposing to mandate that account percentage return information be provided to retail clients. As set out in Attachment E, Dealer Members not currently providing percentage return information to their retail clients will be given 2 years to implement this reporting requirement on a prospective basis. In addition, Dealer Members currently providing percentage return information

to their retail clients, will be given six months from the date of implementation to adopt either a time weighted or dollar weighted calculation method acceptable to IIROC to calculate such information.

Amendments have been made to the previous IIROC proposals published in April, 2009 to mandate that account percentage return information be provided to all retail clients.

The proposed Rules and amendments were approved by the IIROC Board of Directors on June 24, 2010. The text of the proposed Rules and amendments is set out in Attachments A through D.

The percentage return should be on an annualized basis and should be compared to an appropriate benchmark. This should be provided on the monthly, or minimum quarterly statements.

Percentage return from inception or periods great than one year are misleading at best if not compared to an appropriate benchmark.

Issues and alternatives considered

In the course of working on the CRM project, IIROC staff consulted extensively with industry participants and the public. As a result, IIROC staff has been presented with a number of different alternatives and perspectives on the issues to be addressed.

Many commenters have raised questions regarding value of the proposed changes in light of the potential costs to industry participants. IIROC staff has continued to receive input on the cost issue throughout the rule-making process and is confident that it is aware of, and has properly considered the issue. To minimize potential costs, wherever possible, IIROC staff has revised the proposal to provide greater flexibility to Dealer Members in complying with the new requirements without compromising the investor protection goals of the CRM project.

Many industry participants have also suggested that the regulatory objectives of CRM should be addressed through broad principles-based requirements alone. IIROC staff recognizes that there are advantages with principles-based Rules, but this objective must be balanced with the need to articulate clear and consistent minimum standards.(This is good) *IIROC staff believes that the proposed Rules and amendments strike an appropriate balance, setting out clear standards while allowing a sufficient degree of flexibility to accommodate differences in Dealer Members' business models.*

Consideration was also given to the suggestion that a standard form boilerplate disclosure document be developed to address the relationship disclosure issue. However, while IIROC staff acknowledges that some aspects of the relationship disclosure information may be common to all Dealer Members, we also expect that there will be a great deal of variation between firms regarding the specific products and services provided and the processes Dealer Members put in place to deliver those products and services. We believe that the identification of these differences is essential information for clients to make informed choices as to the different options that are available to them. IIROC staff does not believe that the regulatory objectives of relationship disclosure can be satisfied by simply providing a standard form generic disclosure document that lists products and services that a Dealer Member may or may not offer without differentiating between firms.

The need for consistency across the various segments of the securities industry was also raised in many comments received by IIROC staff. Some of the inconsistencies in the approach to the CRM issues taken by IIROC, MFDA and the securities commissions are due to differences in the way business is conducted by the different types of registrants. In any case, staff has reviewed and revised the proposed changes with a view to ensuring, as much as possible, that there is consistency with the proposed requirements to apply to other industry sectors. To this end, the relationship disclosure content requirements have previously been amended and re-organized.

IIROC staff maintains the position that the relationship disclosure information should function as a foundation document that provides a single reference point for key information on the account relationship. However, in the interests of avoiding duplication of the information, the proposed Rule allows for disclosure provided to clients in other materials to be referenced. In such cases, the relationship disclosure must

contain a summary description of the information and the client must be specifically referred to the other documents that have been provided.

We feel that essential relationship disclosure information should be incorporated in the POE disclosure rather than referred to as this could easily be missed by Clients. To be effective disclosure must be clear and simple in plain English. There should be some information that is mandatory such as qualifications, registration details, discipline history, and approved products.

On the issue of conflicts of interest, IIROC staff has made changes to the proposed Rule to clarify that Dealer Members and Approved Persons must "address" rather that "resolve" conflicts. Separate requirements dealing with the way in which material conflicts of interest must be addressed have also been developed for Dealer Members and Approved Persons. These separate requirements reflect the fact that IIROC recognizes that a Dealer Member, as a financial intermediary, is much more likely to encounter competing client interest situations than an Approved Person.

That's fine provided that the details of the "address" is disclosed as well as how the investors could be impacted.

IIROC staff also notes the potential challenges pointed out by industry participants on the issue of performance reporting. To address the comments we received, the proposed Rule regarding activity reporting has been simplified so that Dealer Members will be required only to disclose the cumulative realized and unrealized income and capital gains/losses on the client's account and adequate implementation transition periods have been proposed for all three performance reporting elements. To provide Dealer Members with greater flexibility, the proposed Rule allows for percentage rates of return to be calculated by either a time weighted or dollar weighted calculation method acceptable to IIROC. The requirement to disclose returns, if reported, on a 1, 3, 5 and 10 year basis has been maintained, but as the requirement will apply on a prospective basis, it is not anticipated that it will create a significant compliance burden on Dealer Members.

Many commenters argued that performance reporting is strictly a service issue and that it should be left up to Dealer Members to decide whether they choose to provide any such reporting to clients. IIROC's primary mandate is however to protect the interests of investors and this responsibility involves, in part, setting minimum service levels for clients. IIROC's position is that it is reasonable to expect that clients receive position cost and account activity information to enable them to determine whether they have gained or lost money on the investments in their accounts and to receive percentage return information to enable them to determine the reasonableness of any gain or loss earned/incurred. (This is good provided it is mandatory for firms to provide annualized rates of return for the various investments as well as the total on the regular monthly or quarterly statements.)

The proposed Rules and amendments will be subject to transition periods to allow for systems changes to be implemented before the amendments become effective. Included as Attachment E are the proposed transition periods (from date of implementation notice publication) for each CRM proposal requirement.

A year should be sufficient with the computer facilities available today. Some firms are already providing this information also in graphics. Failure to provide essential performance information is misleading at best.

We will also be issuing guidance to clarify IIROC's expectations and answer questions on the application of the proposed Rules and amendments. A draft Guidance Note is attached as Attachment F.
As a separate initiative, we had previously published for public comment a draft Guidance Note on "Know Your Client and Suitability". Given that the CRM proposals contain proposed amendments relating to the acknowledgement of the know your client information form and the suitability assessment requirements, we felt it appropriate to re-publish this draft notice as part of the CRM proposals. See Attachment G.

In general the proposals are reasonable and seem well intended. From the comments it would seem there are still some in the industry who are reluctant to improve the service they provide to investors and would prefer to stay with the status quo with no fiduciary obligations and a Buyer Beware environment. Currently investors are being misled and the playing field is far from level. If the industry wants to survive and thrive they must revise their approach and provide a better service to investors.

Many investors have turned to DIY investing or simply investing in ETFs and fixed income because of the disappointments with their "Advisors. It is imperative for the industry that the regulators improve regulation and enforcement and encourage the industry to accommodate change. The internet is empowering people as the situation in Egypt aptly demonstrates. These would not have been possible only a few short years ago.

With internet social networks Canadian investors no longer have to depend upon mainstream media which could be controlled by the major advertisers. Investors are becoming empowered and the ABCP fiasco has already provided evidence in Canada of how investors can be empowered by the internet.

The CRM proposals offer some incremental change but there are other changes we feel are essential to address the unfairness of the current situation. We hope that our comments will be of some assistance as the Client Relationship Model is developed, and hope that you will implement a mandatory requirement for a comprehensive disclosure document at the Point of Engagement to accompany the Know Your Client Form which discloses detail about the investor.

Yours truly

Stan I. Buell, P.Eng.
President