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DELIVERED VIA EMAIL

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Dear Mr. Keller:

RE: Request for comments on draft guidance regarding compensation structures for retail investment accounts (the Notice)

The Investment Industry Association of Canada (IIAC or Association) appreciates the opportunity to respond to the Notice issued for comment on August 14, 2012 by the Investment Industry Regulatory Organization of Canada (IIROC). The IIAC formed a Working Group to assist in developing this submission. There was a strong interest across the IIAC membership to participate on this Working Group, and our submission reflects feedback from small, retail-focused broker dealers to large bank-owned firms with extensive retail operations.

General Comments

The IIAC has some significant concerns with the proposed Notice:

1. The Notice appears to assert that cost to the client is the primary determinant in selecting an advisory account, and does not give due consideration to investors'

informed preferences or to the added value of investment advice tailored to each client. Nor does the Notice consider the cost to the dealers in offering their services.

2. We found the generalized description of advisory accounts to be overly simplistic and does not accurately reflect the diversity of business models.

3. The Notice presumes that certain products are always unsuitable, such as those with embedded fees.

4. The Notice appears to regulate by guidance note. In many instances, the Notice is overly prescriptive and, in some instances, based on what we believe is a misinterpretation of IIROC Rules.

Members suggest that IIROC re-examine the proposed general guidelines developed by the IIAC, which were submitted to IIROC in January, 2008. Members indicated that the IIAC guidelines relating to disclosure, informed decisions, transparency of fees, conflicts of interest and protection of vulnerable clients are worthy of consideration in a revised IIROC Notice. In the absence of IIROC guidelines on fee-based accounts, many members have exclusively relied upon the IIAC guidelines in the last few years. Hence, the IIAC guidelines could serve as a valuable framework for strategic development and effective implementation of future IIROC guidance – obviating unnecessary and duplicative industry efforts.

In addition to outlining members' responsibilities, the IIAC guidelines also recognize the client as an equal and integral partner who shares mutual responsibilities in the decision-making process. Client responsibilities include: providing a full and accurate description of their financial situation; undertaking efforts to understand the difference between a commission-based and a fee-based account and their respective fee structures; notifying the advisor of changes in life circumstance or investment objectives; and asking questions and requesting information from their advisor. No regulations, however well-intended, can replace such client responsibilities, and we question the effectiveness of policies with a main actor missing from the equation. Its absence is also in conflict with the Client Relationship Model (CRM) which emphasizes the important role of both the client and advisor.

Poor Timing of the Notice

While the release of the Notice has been long-awaited by the industry, the Association believes the proposed Notice is ill-timed. Presently, members are in the process of developing systems and operational changes in order to implement the requirements under CRM. Requiring firms to address both CRM and the new compensation structure simultaneously would be extremely challenging and impractical. As a result, we strongly urge IIROC to delay any new release of a revised Notice until after the CRM

requirements are in place. Furthermore, as discussed below on page 4, the Notice as currently drafted appears to impose additional *new* requirements, in particular those related to a suitability assessment at the account opening and an ongoing suitability review.

In addition, the performance reporting requirements – currently being finalized by the Canadian Securities Administrators (CSA) – will impose greater disclosure relating to all fees both at the point of sale and through annual reports on charges and compensation. The Association believes that most of IIROC's concerns laid out in the Notice will be addressed by this CSA initiative. Once the CSA performance reporting requirements have been finalized, the industry will be in a better position to assess the effectiveness of the CSA disclosure requirements. Any residual issues surrounding commission-based and fee-based accounts should be addressed at that time. The IIAC believes it would be premature and result in potentially duplicative requirements if IIROC proceeds with this Notice at the present time.

Description on Types of Advisory Accounts

The IIAC observes that the description and distinction between commission-based and fee-based accounts in the Notice are oversimplified and contain some inaccuracies. It is not correct to indicate that in a commission-based account "a client pays a flat transaction fee for every trade executed". New issues of equity and debt securities are purchased commission-free from the client's perspective. The same is true for new issues of government bonds, and mutual funds may be bought, switched and sold on a no-load basis. Further, commissions are frequently negotiated on individual trades. The definition of commission-based account in the Notice needs to be amended accordingly.

With respect to fee-based accounts, the Notice states that member and advisor compensation is tied to either a flat or percentage-based fee. Some members offer fee-based accounts with a reduced commission per trade on top of the periodic fees, so the definition of fee-based accounts as drafted similarly requires some revision. It is also important to point out that each fee-based account is different in services featured and conditions imposed. Some firms provide a pre-determined number of trades in a given period, and above that number the client incurs fees per trade. Typically, fee-based accounts require maintenance of a minimum account size, and applicable fees vary depending on account size. Certain asset classes may feature widely different fee schedules, and there are products geared towards households which incorporate multi-account pricing. The frequency of fee assessments adds another complication in evaluating fee-based accounts. The services offered and the prices charged are available in any number of permutations. Therefore, the definition of fee-based accounts must exist at a high, principles-based level, while keeping in mind the complexities in pricing of these services.

Cost Does Not Determine Suitability

While cost to the client should be a consideration, it should not be the determining factor. Some clients have indicated that they may prefer a fee-based account simply because they want a simplified approach to account operation and do not wish to feel "nickeled and dimed" whenever they receive a confirmation detailing the commissions paid. Clients recognize fee-based accounts often better align the interests of the investment advisor and themselves, and add a premium on this perceived benefit[1]. Predictable fees and individualized care like financial planning or enhanced tax-reporting are other benefits characteristic of some fee-based accounts. It is impossible to put a dollar value on such benefits or client preference, and the Notice does not adequately consider these non-price factors. The IIAC questions the rationale behind onerous requirements to document that a certain compensation structure is "demonstrably beneficial" to clients on a purely cost basis. Even within the same firm, the services offered and the price charged are available in any number of combinations, and it is a futile exercise to attempt to make one-to-one comparisons between fee-based versus commission-based accounts. For instance, what is the lowest cost account type for an investor hoping to buy a mutual fund who: (a) in a commission-based account incurs trailer fees and an annual management expense ratio (MER) of 1.5%; and (b) in a fee-based account incurs annual fees without a trailer to the advisor and an annual MER of 0.5%?

If a client chooses an account type which ends up being most costly, it may be because the client values certain aspects of the chosen account type. The Notice rightly points out, "the account offering the lowest cost will not necessarily be the only suitable account type" and "will depend on the specific circumstances and informed preference of each client". The IIAC strongly agrees that cost to the client does not determine suitability, and therefore urges IIROC to re-examine the pretense behind the new, onerous requirements relating to suitability assessments and ongoing supervisory procedures.

The IIAC also fears that unrealistic regulatory and compliance expectations set out in the Notice could drive firms to streamline and reduce services offered, and the Notice may lead to unintended consequences at the expense of the investing public. A wide array of products from which clients can choose is in the client's best interest. If enacted, the Notice would put a disproportionate amount of burden on dealers primarily serving investors who do not meet minimum investment thresholds.

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[1] It is not always true that fee-based accounts "[foster] a greater alignment of interests between the investment advisor and the client" as suggested on page 6 of the Notice. For example, in an RRIF account, the investment objective for average investors is capital preservation, not capital appreciation. An advisor whose compensation is tied to the size of the account assets would be ill-served by the RRIF client's investment goal and periodic withdrawals.

Imposition of New Requirements
We recognize that Guidance Notes enable IIROC to communicate its interpretation and expectations surrounding new and existing rules; however, we are concerned that in many instances the Notice imposes new requirements. If mandatory new requirements are meant to be introduced in a Notice rather than providing guidance on how to comply with regulatory requirements, then such requirements should undergo the rigorous rule development process, including industry review and regulatory scrutiny. Below is a discussion which illustrates what we believe is the imposition of new requirements.

The Notice requires cost determination as a part of the suitability review. We find it troubling that the Notice makes numerous references to the need to "assess the suitability of the account type" citing compensation structure "as a significant aspect of account type". We are not aware of any aspect of the CRM rules or accompanying guidance which establishes compensation structure as a key factor of account type. The only reference to account type is found in the *Know Your Client and Suitability* Guidance Note 12-0109:

> The Dealer Member and Registered Representatives, at the time of account opening, should ensure that the account type (margin, trust, option accounts, etc.) is appropriate for the client given the client's particular circumstances.

The above clause relates to accounts such as margin, trust, option accounts and the like, and the IIAC believes Rule 1300.1 does not require a suitability review of fee-based versus commission-based accounts. Suitability reviews of account type constitute a substantial change to Rule 1300.1, and new requirements of this nature should not be introduced in a Notice.

More troubling than the Notice's apparent re-interpretation of existing obligations are the numerous new requirements that the Notice appears to impose. For example, the Notice purports to require:

- "… specific considerations to assist Dealer Members and other regulated persons in meeting these regulatory expectations."

- "Dealer Members should take into account the following factors when assessing the relative suitability of commission-based versus fee-based accounts on behalf of a given retail client."

- Needing to reassess suitability of "account type" or commission structure whenever there is a "portfolio" suitability assessment trigger.

- "Dealer Member or individual adviser will only move a client from a commission-based account to a fee-based account (or vice-versa) when such a change in service offerings is demonstrably beneficial to the client."

- "Dealer Members should from time to time verify the suitability of their clients' existing accounts and, in appropriate circumstances, remind clients of the other compensation arrangement option(s) that may be available. Absent unusual circumstances, it would be reasonable to conduct such a review annually …"

Such requirements go beyond the "guidance" typically expected in a Notice and inappropriately set regulatory expectations. It appears that if a member does not adequately supervise the listed factors, it will fail to meet the regulatory requirements and be subject to scrutiny including disciplinary action. The IIAC believes any material change to Rules which carry such penalties should be communicated through a Rule, and not via a Notice.

Assessing Suitability at Account Opening

The Working Group examined in detail various factors listed in the Notice that our members are asked to consider at account opening. We discuss how every listed factor fails to establish suitability *even* on a cost basis alone and conclude that a factor-based suitability assessment merits little value:

1. Whether the client engages in, or plans to engage in, frequent trading of account positions or, instead, tends to be a conservative, "buy-and-hold" investor

   Future activity cannot necessarily be gleaned from either past activity or investor-stated goals. Novice investors may have no idea how frequently they plan to trade, and experienced investors' trading activity will depend on changes in market conditions as well as individual circumstances. Investor-stated frequency of trading may differ from their actual activity and hence is a poor measure of cost-based suitability.

   An investor executing a "buy-and-hold" strategy with equity securities may incur lesser fees in a commission-based account. Is it suitable for a dealer to recommend a commission-based account to an investor simply because of the lower cost? Especially, when the investor would be foregoing individualized portfolio management provided in a fee-based account and may be slower in achieving their financial goal?

   An investor executing a "buy-and-hold" strategy with mutual funds may incur more or lesser charges depending on the length of time they hold the funds and the mutual funds selected. Fee-based account holders can purchase F-class funds which offer a lower MER with no trailer fees. Compared to a commission-based

account, where an investor may pay an embedded trailer as well as a higher MER each year, a fee-based account may be more cost-effective even for a conservative investor. Additionally, fee-based accounts provide an opportunity for more than just portfolio management, such as financial planning and frequent client-advisor interaction, to name a few.

Further consideration needs to be given to tax implications. Unlike commissions, fees paid for the management of non-registered investments may be tax deductible for income tax purposes. Even if a fee-based account investor paid higher fees as compared to a commission-based account investor, their after-tax cost may in fact be lower as a result of this tax advantage.

2. Whether the client typically makes—or plans to make— frequent requests for investment advice or other enhanced services … that go beyond making and executing suitable investment recommendations for the client

The suggested practice makes unwarranted assumptions that clients adhere to their stated goals and are always forthcoming in disclosing details of their financial affairs. It also sets unrealistic expectations for dealers to scope out the best account type for each client and to monitor account type suitability on an ongoing basis. The sheer diversity of available services and products (detailed on page 3) renders such tasks impossible and further serves to demonstrate the significance of client engagement.

We fear if a member decides an account type for a client which ends up being more costly (because the client deviated from their stated activity), this well-intended regulation can in fact be fodder for distrust between the advisor and client – necessitating complex yet ineffective algorithms to second-guess at disengaged clients' preference and future activity. The Notice should focus on the advisor and client jointly exploring available products and fees associated with each product, so that the client can select the most suitable account type for them.

The Association emphasizes that clients must take responsibility in providing a full and accurate description of their financial situation and preferences and understanding the differences in features and fees across different account types. Proactive client participation is a necessary condition in a successful client-advisor relationship.

3. The client's time horizon

A client's investment time horizon does not necessarily predicate whether a commission or fee-based account would be most suitable as it lends little

insight into their account activity or services being required. For example, all clients with a long time horizon cannot be assumed to adhere to a buy-and-hold strategy where a commission account in some instances may prove more beneficial solely on a cost basis.

4. Whether the client tends to invest primarily in assets that have "trailer" or other embedded fees

Even if a client intends to only invest in securities with embedded fees, it is difficult to rule out the suitability of fee-based programs offered by our members. For example, a client may construct a portfolio of mutual funds or equity new issues for which no direct commission is paid by the client. Value added services such as portfolio rebalancing, enhanced tax and performance reporting, and debit or cheque writing access could still appeal to the client and support the decision to have the client's portfolio held in a fee-based account, regardless of whether investments the client selects have additional fees.

Further, the fact that a product contains an embedded fee does not automatically render it unsuitable for the client. It may be the case that there is no comparable product available on the market which so precisely fits the client's objectives. Provided the client receives disclosure of such fees – which will be required as part of the CSA's performance reporting requirements – it is not accurate to suggest that products with embedded fees are always unsuitable for fee-based accounts and thus clients who purchase such products should be in commission-based accounts.

5. Whether the client is comfortable with the prospect of variable charges over time, stemming from a varying amount of activity in the account, or, rather, places a premium on certainty and consistency of fees or charges

Our members concur that this factor is essential for the client to consider when selecting the type of account they want. Investor's stated plans for future trading, security types, time horizon or any other means to quantify the client's investment profile cannot be used as a basis for a cost-benefit analysis between fee-based and commission-based accounts. The responsibility of members, however, includes explaining the different features and costs associated with each account type and ensuring that clients understand this disclosure.

6. The relative size of the assets in the account

It is not uncommon for investors to have multiple accounts, typically with different dealers. Account value at one institution cannot be used to determine one's risk profile or available investment assets. Only the client can appreciate

> conditions and restrictions associated with each account type offered by different dealers. Our members cannot demand their new clients disclose all brokerage accounts they hold or assume reliability of client-stated information to conjecture the suitable fee structure. While a dealer may offer different types of accounts, an individual advisor may service just one type. Are dealers to force investment advisors to offer every type of account irrespective of their expertise and different clientele?

Even if we assume account type suitability can be determined solely based on cost to the client, none of the suitability factors leads to any meaningful prediction of costs. Given the ineffectiveness of each factor when viewed in isolation, the IIAC doubts how these suitability factors when taken together can shed light on the best account type for each client. Not only are these suitability factors poor proxies for client needs, no sophisticated algorithm exists which can predict a client's future activity or their preference. Good policies should focus on effective communication of available products and associated costs to assist the client in making a well-informed decision.

In the foregoing discussion, we assumed that cost to the client alone determines suitability for argument's sake. The Association does not consider this assumption valid. Non-price factors such as client preference must be given due consideration, since cost to the client is merely a small subset of suitability considerations.

Documentation for Account Type Switch

The Association seeks further clarity regarding the expectation that:

> A Dealer Member or individual advisor will only move a client from a commission-based account to a fee-based account (or vice-versa) when such a change in service offerings is demonstrably beneficial to the client.

We request clarification on what demonstrable benefit our members are expected to document when a client moves from one advisory account to another. The Association maintains that policy guidelines should focus on providing transparent disclosure of services and costs associated with different account types.

Disclosure

We are concerned that under this section, IIROC is imposing additional disclosure requirements. While IIROC recognizes that the CRM relationship disclosure information will become effective in March 2013 for new clients and March 2014 for existing clients, the Notice goes on to prescribe interim disclosures which would require separate implementation time frames to allow for orderly updates of disclosure documents and internal procedures.

In the meantime, member firms are currently preparing their relationship disclosure documents which will have a detailed discussion of charges and fees incurred by clients as part of the operation of their accounts. The creation of interim disclosure requirements while firms are working on the CRM relationship disclosures will result in overlap in transition periods and additional implementation challenges for the firms. As a result, any discussion of the interim disclosure provisions should be removed from this Notice in recognition of CRM initiative.

Account Supervision

Acknowledging Rule 2500 was designed with commission-based accounts in mind, the Notice delineates new triggers specific to fee-based accounts as a corollary to Rule 2500. Our members observe that many of these triggers, other than certain high risk trading activities, are not currently set out in Rule 2500. The IIAC seeks clarification as to whether these are new, additional regulatory expectations for trigger-based monitoring specific to fee-based accounts. Other than the manner in which the client is charged, there is no difference between the potential transaction or account concerns which can arise in either fee-based or commission-based accounts. The Association recommends reviewing of the IIAC guidelines related to regular monitoring of accounts.

If, on the other hand, IIROC expects monitoring of these factors, we seek clarification on what IIROC considers “high risk” trading activities in fee-based accounts.

The IIAC is further concerned about the need to monitor supplemental charges in a fee-based account. Generally speaking, fees charged on fee-based accounts are to compensate the advisor for portfolio management, and not intended to cover incidental brokerage charges. Supplemental charges offset costs borne by our members in rendering services unrelated to investment advice, and they exist in commission-based and fee-based accounts alike. These fees typically arise from withdrawals, wire-transfers, cheque requests and rush service. We ask why the monitoring of these charges is recommended for fee-based accounts, when no comparable requirement exists for commission-based accounts. Unless IIROC wishes to impose the number of non-investment advice requests a client can make, this item should be removed.

A product feature of fee-based accounts sometimes includes a pre-determined number of complimentary trades in a given period with the client incurring fees for trades exceeding their allowance. Since commission-based accounts have no such feature, this supplemental charge is unique to fee-based accounts. It is important to note that periodically assessed fees in fee-based accounts are used to compensate the advisor for their investment advice, not transaction costs. A corollary of which allows fee-based clients to deduct fees paid for investment advice for their income tax purposes. The monitoring of supplemental charges as suggested in the Notice seems to be predicated on the false notion that fee-based account clients are paying for investment advice as well as transaction costs. The Association reiterates that periodic fees in fee-based

accounts are remuneration solely for advisory service and should not be mistaken to entail transaction costs. Transaction allotment is merely a product feature of fee-based accounts. Any suggestion to the otherwise calls into question tax deductibility of fees and leaves fee-based clients vulnerable to assessment by CRA.

Ongoing Review of Compensation Structure Suitability

Another example of the Notice imposing new requirements (or misinterpreting CRM) relates to the ongoing review of compensation structure suitability:

> Dealer Members should refer to the new mandatory suitability assessment triggers adopted as part of CRM and, starting on the relevant effective date, should begin to include a review of the client's account type and compensation structure as part of any suitability analysis triggered by one or more of the events specified in the new rule.

Rule 1300.1(r) recommends to "use due diligence to ensure that the *positions held* in a client's account or accounts are suitable for such client". The trigger factors are used only to determine suitability of the positions held in the account and do not extend to a suitability review of account types. The occurrence of one of the trigger factors, therefore, has no bearing on either the account type or compensation structure, and Rule 1300.1(r) does not dictate a suitability review of compensation structure.

Further, the Notice also states that it would be reasonable to conduct a suitability review on an annual basis. There is no such requirement under CRM to verify the suitability of account type either on an annual basis.

Double Charging

The IIAC expresses reservation about the use of the colloquial term "double charging" in the Notice[2]. It casts our members in an undeservedly negative light and seems to imply the industry willfully engages in abusive practices at odds with the interest of the investing public. Fee-based accounts were introduced to the market to better assist clients by providing predictability in brokerage fees and offering individualized portfolio management customized to each client. It is crucial to point out the existence of a potential dual fee is neither designed nor promoted by members. Rather, these charges are often the inadvertent consequence of many new securities being packaged and marketed to commission-based brokerages. We recommend use of terms like "embedded-fee securities" or "investment products with embedded commission".

Despite marked improvements in the last four years, there are extraneous factors which pose a significant impasse to alleviate issues surrounding embedded-fee securities.

[2] The Working Group has similarly expressed concerns about the use of the term "double-dipping" in the 2008 IIAC guidelines on fee-based accounts.

While the percentage of retail brokerage assets held in fee-based accounts has rapidly grown, commission-based accounts still represent almost 60% of assets in Canada, and the issuance of new securities featuring embedded-fees persists to be a standard practice. Our members have been successful to some degree in offering ‘no-load shares’ for mutual funds and ETFs in fee-based accounts, but our members cannot compel investment issuers to abandon the widespread practice which may impede issuers’ ability to raise capital. It is therefore inappropriate to presume that, given there may not be a viable alternative to an embedded-fee security, such securities are always unsuitable for fee-based clients.

The Notice goes on to delineate factors that IIROC believes are standard industry practices to avoid double-charging for embedded-fee securities: offering fixed income assets at the prevailing market price; recommending no-fee investments; and rebating account fees. It is inaccurate to suggest that all three are currently employed industry practices. As dealers with different business models and clientele may have varying degrees to which the issue of embedded-fee securities impacts their fee-based clients, it would not be appropriate to make mandatory the three practices. A client with a fee-based account with a small, retail-focused dealer may have limited opportunity to purchase new securities, and imposing a set of rules across the industry irrespective of each dealer’s specific circumstances may be counterproductive. The IIAC advocates clear and meaningful disclosure of third party compensation to clients. Dealers must also take steps to ensure that the client understands the meaning and implications of the disclosure.

Vulnerable Clients

While the vast majority of clients in advisory accounts are capable, well-informed investors, there may exist some clients who may not be able to appreciate the costs that they are incurring in a fee-based account. If a dealer has a well-grounded reason to conclude that a client is unable to make informed decisions about their own financial affairs, then the firm should implement controls to provide reasonable assurance that those clients are not taken advantage of.

The IIAC and the Working Group would be happy to meet with IIROC to discuss our concerns in greater detail. If there are any questions regarding our submission, please do not hesitate to contact either of the undersigned.

Yours sincerely,

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