Statutory Fiduciary Duty or Best Interest Standard

Speech to USCO Annual Convention by Diane A. Urquhart,
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I would like to thank Bernard Jordan and Marie Smith for inviting me to speak to you today about the proficiency and duties of financial advisors in Canada.

I wish to open my talk by asking you to raise your hand if you believe your doctor should act in your best interest when treating you for an ailment?

You are right, Canadian law requires this.

Now raise your hand if you believe the lawyer holding your down payment for a house has fiduciary duties to protect this money while it is in his possession?

You are right, Canadian law requires this.

Finally, raise your hand if you believe your financial adviser should act in your best interest, putting you ahead of himself and ahead of his employer.

Well your show of hands is consistent with a recent survey by the Canadian Investor Education Fund that showed 7 in 10 investors believed there is a duty for financial advisers to put their clients first.

But, did you know that Canadian law does not require financial advisors to put client's interests first. There is no statutory fiduciary duty standard applicable to financial advisors in Canada!

Think about it! Financial advisors impact when you retire and what your retirement income will be. They impact the quality of your life, if you were to become disabled. Your partner and children will be affected by flawed savings and insurance products and strategies, if you were to die. The financial adviser's role in your life events is comparable to other professionals who must meet the fiduciary duty standard: doctors, lawyers and trustees protecting the beneficiaries of trust accounts.

The 2007 to 2009 financial crisis has been a rude awakening about the banks designing savings and investment products for their clients that were destined to fail and they knew it. Make no mistake; the Canadian banks are equally guilty of misconduct, despite heavy promotions to the contrary.

Think about the $200 billion of income trusts that the NPSCF and USCO helped to shut down in 2006. Think about the $32 billion of Non Bank Asset Backed Commercial Paper, where after a vigorous fight we achieved the largest securities settlement in Canadian history in 2009. Both income trusts and ABCP were toxic investments, where investors lost one third of their money invested.

The banks got huge undisclosed fees and spread profits on these very risky products, which are marketed as low risk. Sophisticated industry players took advantage of seniors buying these products to produce a retirement income. The credit rating agencies were part of the gig,

giving triple AAA credit ratings on what is now referred to as toxic waste.

Responsibility for funding the costs of living during old age is shifting more to investors.
Only 2 in 10 private sector employees are in a defined benefit pension plan. New and younger employees have defined contribution pension plans at work or must save on their own through RRSPs. The investors buying income trusts and Non Bank ABCP were not greedy. They simply trusted the marketing materials of the banks and believed in the integrity of banks. They thought credit rating agencies were working for them.

It is practically impossible for young people to save for their retirements due to the impact of
hidden advisor and dealer compensation arrangements in mutual funds that create a conflict of interest between the interests of advisors and dealers and their clients. For example, average mutual fund fees of 2.4%, include undisclosed 0.5% to 1% retainer fees paid to financial advisors to keep you in mutual funds. The composite mutual fund fees are taking over half of savers' investment return over a 30 year savings horizon. Do the banks and mutual fund companies really need to take half of your investment return in order to make a reasonable return for their shareholders?

Even if you were not buying the savings products which failed, you are being impacted as pensioners, bank depositors and taxpayers. Banks throughout the world have received trillions of dollars of tax payer bailouts and multiple support programs to provide liquidity in order to avoid bank failures.

A recent Chartered Financial Analyst Institute Sentiment Survey in 2013 found that 98% of members acknowledge current lack of trust in financial industry. My question is: who are the 2% with CFAs who have trust in financial institution CEOs and CFOs.

Seniors and pension funds are prominent amongst the victims of the financial repression policies of the central banks throughout the world over the past five years, of low interest rates and money printing. Financial repression is giving many banks in the world life support, until they raise new capital to shore up their balance sheets.

Banks and governments have become deeply intertwined causing banks to be spared the need to be held responsible for the losses they created with their high risk taking activities. Current central bank policies favour the banks and Canadians who borrow money and punish the prudent people who saved their money and avoided high debts.

Seniors on fixed income will suffer lower standards of living as inflation inevitable rears its head down the road due to the unprecedented money printing throughout the world.

I encourage the USCO to join me in supporting the new proposal of the Canadian Securities Administrators to legislate a new statutory fiduciary duty standard, or best interest duty standard, for financial advisors, who give advice to retail clients.

The Canadian Securities Administrators define this new standard to mean:

Every adviser and dealer … that provides advice to a retail client with respect to investing in, buying or selling securities or derivatives shall, when providing such advice,
(a) act in the best interests of the retail client, [ahead of their own or their employer's interests]
(b) exercise the degree of care, diligence and skill that a reasonably prudent person or company would exercise in the circumstances.

The new fiduciary duty standard must not be restricted to just financial advisors. It must apply to the employers who supervise the financial advisors. It must apply to the investment bankers and research professionals at investment dealers, who design and provide expert opinions on complex investment products sold to retail investors. Otherwise, the financial advisors are left holding the bag, when flawed investment products fail.

I also encourage the USCO to support the recommendations of the financial advisors' association, Advocis. Advocis has numerous recommendations for raising the bar on professional standards for financial advisors. Advocis wants mandatory membership in an accredited professional association and higher initial qualifications for licensing. Do you know that you can become a financial adviser after taking just a six week correspondence course? There is no university degree requirement like that of doctors, lawyers and engineers.

Advocis seeks to require continuing education, a complaints and discipline process, and publications of the names of person who breached the professional standards and code of conduct set by the professional association.

Both the new statutory fiduciary duty standard and increased professional standards are required for retail customers to regain trust in the financial industry. Self-regulated professional standards are not enough.

The new statutory fiduciary duty will be helpful to both government securities and insurance regulators and the courts. A new statutory civil liability regime is also needed. This would allow investors to benefit from private class actions, when securities and insurance regulators and the police ignore their claims of financial industry wrongdoings.

The statutory fiduciary duty standard eliminates the time consuming and costly aspects of regulatory and civil court proceedings that deal with whether or not a fiduciary duty relationship exists. The adjudicators can focus on the evidence of whether fiduciary duty was carried out and whether the financial adviser acted as a reasonably prudent person.

The Ontario government's adoption of the new fiduciary standard will raise the bar for financial advisors and banks. Seniors can be at the forefront of encouraging this change as they were in the generation of savers, who operated on trust and integrity.

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IIROC Know Your Client/Suitability Rules

Rule 1300 is a broad provision that requires a Dealer Member to ascertain the identity of its client and to ascertain the suitability of every transaction for all customers.

Rule 1300.1 details the "Know Your Client/Suitability" rules that every Dealer Member in Ontario must comply with when transacting business on behalf of every customer.

(a) Each Dealer Member shall use due diligence to learn and remain informed of the essential facts relative to every customer and to every order or account accepted.;
(p) Subject to *Rule 1300.1(r)* and *1300.1(s),* each Dealer Member shall use due diligence to ensure that the acceptance of any order from a customer is suitable for such customer based on factors including the customer's financial situation, investment knowledge, investment objectives and risk tolerance.
(q) Each Dealer Member, when recommending to a customer the purchase, sale, exchange or holding of any security, shall use due diligence to ensure that the recommendation is suitable for such customer based on factors including the customer's financial situation, investment knowledge, investment objectives and risk tolerance.
(r) Each Dealer Member that has applied for and received approval from the Corporation pursuant to *Rule 1300.1(t)*, is not required to comply with *Rule 1300.1(p)*, when accepting orders from a customer where no recommendation is provided, to make a determination that the order is suitable for such customer;
(s) Each Dealer Member that executes a trade on the instructions of another Dealer Member, portfolio manager, investment counsel, limited market dealer, bank, trust company or insurer, pursuant to *Section I.B (3)* of *Rule 2700* is not required to comply with *Rule 1300.1(p)*.

RULE 2700 – Minimum Standards for Institutional Account Opening, Operation and Supervision

B. Customer Suitability

1. When dealing with an institutional customer, a Dealer Member must make a determination whether the customer is sufficiently sophisticated and capable of making its own investment decisions in order to determine the level of suitability owed to that institutional customer. Where a Dealer Member has reasonable grounds for concluding that the institutional customer is capable of making an independent investment decision and independently evaluating the investment risk, then a Dealer Member's suitability obligation is fulfilled for that transaction. If no such reasonable grounds exist, then the Dealer Member must take steps to ensure that the institutional customer fully understands the investment product, including the potential risks.
2. In making a determination whether a customer is capable of independently evaluating investment risk and is exercising independent judgment, relevant considerations could include

a. any written or oral understanding that exists between a Dealer Member and its customer regarding the customer's reliance on the Dealer Member
b. the presence or absence of a pattern of acceptance of the Dealer Member's recommendations
c. the use by a customer of ideas, suggestions, market views and information obtained from other Dealer Members, market professionals or issuers particularly those relating to the same type of securities
d. the use of one or more investment dealers, portfolio managers, investment counsel or other third party advisors;
e. the general level of experience of the customer in financial markets
f. the specific experience of the customer with the type of instrument(s) under consideration, including the customer's ability to independently evaluate how market developments would affect the security and ancillary risks such as currency rate risk; and
g. the complexity of the securities involved

3. No suitability obligation shall exist pursuant to Section B(1) nor is a determination required under Section B(2) where a Dealer Member executes a trade on the instructions of another Dealer Member, a portfolio manager, investment counsel, limited market dealer, bank, trust company or insurer

<u>Ontario Securities Commission "Know Your Client and Suitability" rules</u>

Section 31-505 Ss. 1.5 and 1.7 of the Ontario Securities Commission Rules ("OSC Rules") further describes the "Know Your Client and Suitability" rules:

1.5 Know your Client and Suitability

(1) A person or company that is registered as a dealer or adviser and an individual that is registered as a salesperson, officer or partner of a registered dealer or as an officer or partner of a registered adviser shall make such enquiries about each client of that registrant as;

(a) subject to section 1.6, enable the registrant to establish the identity and the creditworthiness of the client, and the reputation of the client if information known to the registrant causes doubt as to whether the client is of good reputation; and

(b) subject to section 1.7, are appropriate, in view of the nature of the client's investments and of the type of transaction being effected for the client's account, to ascertain the general investment needs and objectives of the client and the suitability of a proposed purchase or sale of a security for the client.

(2) Despite paragraph (1)(a) a registrant is not required to make enquiries as to the creditworthiness of a client if the registrant is not financing the acquisition of securities by the client.

1.7 Execution of Trades and Instruction

Paragraph 1.5(1)(b) does not apply to a registered dealer or a registered salesperson, partner or officer of a registered dealer that executes a trade on the instruction of a registered adviser, another registered dealer or a Canadian financial institution