CFIQ CONSEIL DES FONDS D'INVESTISSEMENT DU QUÉBEC

La voix au Québec de l'Institut des fonds d'investissement du Canada

TRANSLATION OF ORIGINAL LETTER WHICH WAS SUBMITTED IN FRENCH

BY E-MAIL: consultation-en-cours@lautorite.qc.ca

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Dear Ms. Beaudoin:

Re: CFIQ comments on Consultation Paper 33-403 from the CSA: "Standard of Conduct for Advisers and Dealers – Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients"

The Quebec Investment Funds Council ("CFIQ") hereby provides its comments regarding Consultation Paper 33-403 titled Standard of Conduct for Advisers and Dealers: Exploring the Appropriateness of Introducing a Statutory Best Interest Duty When Advice is Provided to Retail Clients ("Consultation Paper").

CFIQ represents most mutual fund management companies and mutual fund dealers who do business in Quebec. Its manager members oversee over $140 billion in assets under management and its dealer members are responsible for the large majority of mutual funds distribution in the province. CFIQ is the Quebec wing of the Investment Funds Institute of Canada ("IFIC").

We would, first of all, like to thank you for the opportunity to provide you with our comments on the content of the Consultation Paper. We are of the opinion that it affects many aspects of the mutual funds investment industry.

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Please note that CFIQ agrees with all of the comments submitted by IFIC in the course of the consultation process. However, CFIQ feels that it would be useful to point out certain Quebec-specific items with respect to the Consultation Paper as well as concerns regarding some of the proposals contained therein.

If you have any questions, please do not hesitate to get in touch with Kia Rassekh, Manager and Senior Policy Advisor for CFIQ, at 514-985-7025, krassekh@ific.ca.

Sincerely yours,

"Original signed by Stéphane Langlois"

Stéphane Langlois
Chairman of the Board of Governors
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I - Discrepancies between the civil law and the common law in terms of fiduciary duties:

Common Law

The Consultation Paper explains the basis for fiduciary duty in the common law provinces. Fiduciary duty is not automatically bound to the services provided by mutual fund dealers. Before deciding that the representative of a mutual fund dealer was in fact acting as a trustee, the courts of common law would first consider the five following criteria:

- The client's vulnerability
- The client's degree of trust in the representative
- The client's reliance on the representative's advice
- The representative's discretionary power
- The representative's rules of professional conduct

When the courts of common law determine that client/representative relationship qualifies as a fiduciary duty, the following obligations must be observed by the representative:

- Client interests remain paramount
- Conflicts of interest are avoided
- Clients are not exploited
- Clients are provided with full disclosure
- Services are performed reasonably prudently

The Consultation Paper recommends the institution of a best-interest standard strongly inspired by common law principles governing fiduciary acts.

Quebec Civil Rights

In Quebec, the Civil Code of Quebec (CCQ) adds a few duties for dealers to the ones contained in the Quebec Securities Act (QSA). For example, when the relationship between a client and a mutual fund dealer, or one of his or her representatives, ("dealer") is qualified as a "contract for services" or a "mandate," or if the dealer is affiliated with an administrator of the property of others, the dealer is duty-bound to act in the best interest of his or her client.

This legal qualification of the relationship between a dealer and his or her client is important, as it means the specificity of relationships of trust can be assured by intensifying the standards of conduct, and accordingly, the sanctions imposed on dealers not complying with their obligations can be intensified.

In an article published in the *Revue du Barreau* (the bar review)/Tome 61/Fall 2001, "*Les devoirs de loyauté des administrateurs de sociétés par actions fédérales – impact du Code civil du Québec*" (the duty of loyalty of federal business corporation administrators – impact of the CCQ), Paul Martel lists the duties of administrators of the property of others [translation]:

The administrator of the property of others

> "Administrators of the property of others (notably including estate executors, tutors, trustees, fiduciaries, receivers and managers of joint ownerships) are bound by duties of honesty and loyalty. They must act in the best interests of the beneficiaries, avoid conflicts of interest, denounce them wherever they are found or likely to be found, stay out of any agreements involving the managed property and not acquire rights on it, never confuse the managed property with theirs, and never use the managed property or any information obtained by virtue of its management for their own benefit, except with the beneficiary's consent. They are to report all of a beneficiary's personal profits and benefits to him or her, and compensate a beneficiary if they use an item of property without authorization. These duties closely match those defined as fiduciary duties in the common law."

The mandatary

> "Mandataries are also subject to duties of honesty and loyalty, but to a different extent. They must act in the best interests of the mandator and avoid conflicts of interest. Unless authorized to do so by their mandator, they may not use the property they are entrusted with or the information they obtain for their own benefit. They may not be a party to an act they have agreed to carry out for their mandator unless the mandator approves or is aware that the mandatary is a co-contracting party with a duty of full accounting at the end of the mandate."

The service provider

> "The contractor and the service provider are bound to act in the best interests of their client, although the CCQ does not address their duty of loyalty and honesty. They are nevertheless bound by a duty to inform clients of the nature of their work, as well as the material and time it requires, and a duty to justify any increase in prices."

Our review of Quebec jurisprudence in terms of dealer responsibilities indicates that a client/dealer relation generally qualifies as a mandate. Once this qualification of the client/dealer relation is established, Quebec courts define the scope of the mandate based on the facts specific to the litigation submitted to them.

Article 2138 of the CCQ calls on mandataries to act prudently, diligently, honestly, loyally and in the best interest of the client. There is, therefore, no need to demonstrate vulnerability, degree of reliance and the other criteria considered by the courts of common law in order to trigger the duty to act in the client's best interest.

The "best interest of the client" standard found in the common law's fiduciary duty is therefore codified in the CCQ and applied by Quebec courts when the time comes to determine whether a dealer is responsible to a client. Through the years, the courts have applied the mandate rule by adapting the extent of obligations to the particulars of each case. If clients entrust their investments to a representative and rely entirely on the latter's expertise, the courts are more likely to apply the mandate rule more strictly. They will generally factor in the analysis carried out by the representatives and their review of the case, their knowledge of the client, their choice of investment and their recommendations. Should the court decide that a fault has been committed, it will assess the prejudice sustained by the client as a result of the fault in determining its sanction.

In order to account for the particulars of each case, it is essential for Quebec courts to retain this flexibility when it comes to applying dealers' duties in the performance of a mandate. The consequences of imposing a strict best-interest standard based on certain aspects to the detriment of other important items associated with a particular case lead to some uncertainty.

As an illustration, if the strict duty to act in the client's best interest requires the dealer to offer a product at the best price, the court will have to consider this criterion in its evaluation, even though the cost of the product has never been a problem in the particular case before the courts. This could needlessly complicate the situation for the courts and generate extra costs for dealers in order to be able to meet a new standard, one for which no benefit for the client has been demonstrated. In addition, the strict best-interest standard suggested by the Consultation Paper introduces the best product rule, although without emphasizing it. The courts' interpretation as to the best-interest duty, relative to the qualification of the mandatary as a dealer, does not require the dealer to sell the product at the lower cost.

Notwithstanding the foregoing, CFIQ dealers have also been confronted with the various concerns listed in Point 6 of the Consultation Paper ("Concerns"). We are in fact of the opinion that the statutory regime currently applicable to dealers provides an effective regulatory framework enabling both investors and dealers to plead their cases before the courts of that province. Quebec's statutory

framework regarding the responsibility of dealers does address some of the concerns raised in the Consultation Paper, and we do not feel that it is necessary to amend the best-interest rule as it already exists in Quebec. This province's courts have decided to apply duties specific to dealers on a case by case basis, stemming from the legal nature of the relationship they entertain with their clients.

CFIQ suggests that the varied nature of services offered by registered firms and the different business structures characterizing individual firms make it impractical to adopt the strict best-interest standard, as proposed in the Consultation Paper. In our opinion, the legal qualification work currently being done by the courts of Quebec in their application of the CCQ's stated duties is very well adapted to the environment in which dealers operate. (See also the appendix of the IFIC submission on the Consultation Paper on rules currently in force in Quebec.)

Inasmuch as dealers are already required to act fairly, honestly and in good faith in their relations with clients and to act with all the care that may be expected of a knowledgeable professional acting in the same circumstances, as per the QSA, the only notions not expressly addressed by the QSA's and the CCQ's stated standards of conduct governing the acts of a common law fiduciary are the notions of pre-eminence of the client's interests and absence of conflicts of interest.

As for the basic common law principle whereby fiduciaries must avoid placing themselves in conflict-of-interest situations, we will deal with the topic in a later section.

We would respectfully submit that the best-interest duty already derives from all previously stated Quebec obligations and regulations governing the service offering of dealers:

- The mandate rules stipulated in the CCQ
- The obligation to act in good faith, fairly and honestly, and to demonstrate the diligence exercised by a professional in the same circumstances described in the QSA
- Existing rules in matters of propriety, conflicts of interest, business conduct and information, including those adopted by the self-regulatory organizations (SROs)

In light of the foregoing, we estimate that imposing a strict best-interest diligence standard, as recommended in the Consultation Paper, is not desirable. Neither is it the best approach for addressing the Concerns.

II- CFIQ concerns and observations regarding the Consultation Paper

As previously mentioned, CFIQ is issuing this opinion to add certain comments to those made by IFIC on current Canadian regulations on conflicts of interest experienced by dealers, as well as business conduct guidelines. To begin with, CFIQ would also remind the Canadian Securities Authorities ("CSA") that dealer representatives are currently subject to ethical obligations under the supervision of the *Chambre de la sécurité financière*.

Conflict-of-interest situations

We understand the concerns of the CSA as to the presence of conflicts of interest between dealers and clients. On the other hand, we believe that not all conflicts of interest can be eliminated by compelling dealers to apply rules of conduct similar to those of a trustee under common law, as recommended in the Consultation Paper.

We respectfully remind the CSA that conflict-of-interest rules and guidelines were adopted in September 2009 with the passing of Regulation 31-103 on Registration Requirements and Exemptions (Regulation 31-103) and its National Instrument. We are of the opinion that the observance of the approach to conflicts of interest found in the National Instrument associated with Regulation 31-103, when combined with adequate disclosure of conflicts of interest to clients can considerably mitigate any form of negative perception regarding such conflicts of interest.

For example, it is highly unlikely that not paying their dealers a direct compensation means that investors do not know that the dealers are getting paid for their work. It is our belief that investors are more concerned with whether the dealers they are doing business with are competent and whether they are fully disclosing any relevant information the clients may require to properly understand their mutual relationship. Investors also want to be informed of the nature of the compensation received by the dealer. There are already regulations requiring full disclosure of the compensation paid to dealers in different informative documents and the "Fund Facts" paper. In addition, the latest IFIC study shows that one half to nearly two thirds (63%) of investors recall having discussed expenses, compensation of dealers and management fees with their dealers at their latest mutual fund purchase. Also, a majority of investors (73%) declare themselves to be at least somewhat confident that they properly understand the fees they pay for their mutual funds.[1] We feel that the current system for reporting conflicts of interest, notably via the disclosure of compensation, meets client expectations and sets the stage for

[1] A 2012 Pollara report: "Canadian Investors' perceptions of mutual funds and the mutual fund industry," prepared for IFIC.

proper management of the appearance of conflicts of interest stemming from the compensation of dealers.

We are also of the opinion that certain conflicts of interest related to the actual structure of some of the industry's stakeholders cannot be totally avoided. In fact, the decompartmentalization of the financial services industry since the mid-1980s has concentrated various activities among a number of financial groups, some of which are registered firms. This concentration of financial services within a single group has not only opened access to a variety of securities and services for retail investors, but also emphasized the appearance of conflicts of interest. However, the CSA addressed this new reality by adopting certain rules and measures aimed at regulating certain forms of conflict of interest, such as the creation of independent review committees.

For example, the fact that a dealer recommends that a client acquire units in an investment fund managed by a registered firm is not in itself a disadvantage for the client, but may, nevertheless, look like a conflict of interest. In many cases, it is easier for clients to do business with a single firm that belongs to a group of firms and can therefore provide a full range of services. We are of the opinion that applying fiduciary duty in accordance with the common law, as proposed in the Consultation Paper, could cast some doubt on such firms, despite the fact that clients are drawing a definite benefit from them.

Business conduct guidelines

CFIQ is of the opinion that appropriate disclosure remains the key to success. Regulation 31-103 and its attendant national instrument already have stated rules concerning disclosure. We feel that the best way for the CSA to address some of the Concerns would still be to review the current rules and the way their application is monitored.

We feel that the confusion that Quebec investors may feel as to the nature of their relation with registered firms resides, at least partly, in the fact that services of a very similar nature may be offered by different registered firms. Investors are notably given financial advice and other services of that type by a multitude of people from a variety of sectors (e.g. insurance, securities investment, portfolio management and financial planning), or by a single person with multiple registrations.

CFIQ believes that the best way to alleviate certain concerns is to arrive at a better definition of current business conduct guidelines, and to implement better monitoring of their application.

One approach to define business conduct guidelines would be to publish a list of business practices and behaviours currently seen in registered firms deemed either appropriate or inappropriate in light of the Concerns. Such an initiative would enable the CSA to describe good and bad practices in each

category of registered firm and thus develop a clearer understanding of what constitutes proper business practice so that the industry can make the necessary changes, as warranted. The CSA would thus be able to send clear messages to industry participants rather than having to adopt a vague, general standard based on common law principles governing fiduciary duties.

The Chambre de la sécurité financière and the SROs

CFIQ would remind the CSA that the representatives of mutual fund dealers are governed by a code of ethics overseen by the *Chambre de la sécurité financière* (CSF), which is responsible for its application and already stipulates a best-interest standard.

In fact, both the regulation respecting the rules of ethics in the securities sector (D-9.2, r. 7.1) and the code of ethics of the *Chambre de la sécurité financière* (R.S.Q. c. D9-2, r.3) lay down rules obliging representatives to act in a loyal manner and keep the client's best interests paramount. Representatives must act professionally and carry out a detailed analysis before making recommendations. The best-interest rule is an integral part of their business conduct rules, which rules they must follow under penalty of disciplinary sanctions. The CSF bases itself on these rules to arrive at its administrative decisions. Failure to fulfill the mandate or to subordinate one's personal interest is among the infractions most frequently sanctioned by the CSF's disciplinary committee.

We believe that the solution to the concerns is more contingent on increased support by SROs and the *Autorité des marchés financiers* (AMF). CSF initiatives such as "*Info-déonto*" (ethics info) and the issuance of rules regarding compulsory attendance at compliance-based "professional development units" are constant reminders to the members to observe their ethical obligations. The AMF's newsletters and other publications are also necessary to help dealers understand the regulatory agency's interpretations. There are rules aplenty and they are constantly being expanded on, which makes it difficult to keep up with the changes. Dealers must therefore have useful tools at hand and constant support from the regulatory agencies and the SROs.

There is no indication that enforcing a new standard would bring any benefit in addressing the Concerns. Dealers have obligations as to means, not as to results. As proposed in the Consultation Paper, the standard could be interpreted as an obligation as to results (best product/best price), which would put a disproportionate onus on the shoulders of dealers.

It should also be noted that, in Quebec, investors have access to a number of options to settle their disputes. Under Regulation 31-103, for example, the registered firm must provide an independent dispute-settling mechanism to deal with client complaints. In Quebec, this independent service is assured by the AMF. Clients of mutual fund dealers may also address claims to its financial services

compensation fund in the event of fraud, fraudulent tactics or embezzlement. Investors can also resort to various courts of common law.

III - Financial literacy

The efforts deployed by the AMF to promote financial literacy basically consist in increasing investor knowledge so they can better understand the financial products and services they are offered. In a September 2012 research paper titled "*Littératie financière et préparation à la retraite au Québec et dans le reste du Canada*" (Financial literacy and saving for retirement in Quebec and the rest of Canada), authors Thomas Lalime and Pierre-Carl Michaud made the following observation [translation]:

> "Our results show that Quebec lags far behind the rest of Canada in terms of not only financial literacy but also financial education. These differences are still apparent even after data are bracketed for a good number of socio-economic factors. This gap translates into a smaller proportion of workers being able to affirm that they are actually preparing for retirement and a lower number of households participating in financial markets (stocks, bonds, and so on)."

There might be a correlation between the expansion of standards of conduct in the industry and the Quebec public's lack of interest in developing financial literacy. Our duty is to elicit the interest of investors by recommending they get better informed about their financial needs, and that they discuss the issue at length with the dealer when the time comes for them to invest.

We feel that the strict standard requiring the dealer to act in the best interest of the client, as recommended by the Consultation Document, may conversely prompt investors to shed responsibility and lose interest in the services they receive from the dealers. We must at all costs avoid instituting a system in which investors would have little interest in the selection of their investments for the simple reason that the dealers would ultimately be held accountable for any and all financial choices made.

We believe that educating Quebec investors and holding them more accountable are the pathways we should follow in order to address Quebec's knowledge gap in terms of financial literacy.

Conclusion

We are of the opinion that for all of the reasons mentioned hereinabove, the strict best-interest standard, as proposed in the Consultation Paper, should not replace the standard currently governing dealers in Quebec. The application of rules currently in effect in Quebec has demonstrated that clients are sufficiently protected in their relation with their dealers. The same rules would also enable the courts to intensify rules of conduct applicable to dealers on the basis of the facts specific to each case. Legislators have long since decided to distinguish among the duties applicable to dealers and advisors,

depending on their legal relation and the facts specific to each case, and we therefore see no reason justifying any change to this approach.

Over the last few years, in a bid to increase the protection afforded to investors, the CSA and the SROs have adopted numerous rules governing the conduct of dealers. We are of the opinion that the best way to address many of the Concerns resides in the application and improvement of the rules already in place.