Submission to the Canadian Securities Transition Office (CSTO)

A New View of Securities Regulation in Canada – Continuing the Dialogue with the CSTO

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The Financial Advisors Association of Canada

Executive Summary

The Canadian Securities Transition Office (CSTO) is taking a fresh look at securities regulation through its mandate to create a national securities regulator and a Canadian securities act. This represents an enormous opportunity to address significant structural problems in the current system.

A high level review of financial service regulation over a number of years provides clearly observable facts. Regulatory budgets are growing to accommodate the increasing reach of the regulators. Regulation and compliance are often needlessly and increasingly complex as regulation comes from not only senior regulators but their proxies, the SROs (MFDA and IIROC). Providers of financial services are increasingly ensnared by more rules-based regulatory requirements while consumers are less able to afford and access professional financial advice.

The regulators continue to regulate and impose costs on compliant financial advisors, but fail to identify and deal effectively with bad actors through their enforcement powers. This is limiting both choice in the marketplace and access to professional financial advice for Canadians.

Advocis believes that significant change is needed to improve securities regulation in Canada.

Attached as Appendix "A", the ***Technical Analysis***, provides a more detailed review and analysis of the issues addressed in this submission.

Recommendations:

1. The proposed draft securities act should be principles-based with all rules, instruments and policies developed from a Principles Based Regulation (PBR) platform and focused on achieving the desired regulatory outcomes. PBR should also apply to rules and policies developed by the SROs.

2. The draft securities act should stipulate that attention must be paid to proportionate regulation both at the issuer level and the distribution level.

3. There needs to be a reexamination of who should be regulating financial advisors. This should include a thorough review of the role of SROs (MFDA and IIROC).

4. The CSTO should recommend the establishment of an Advisor Panel to ensure that small securities registrants have a clear advisory voice in the development of policy. They should also adopt a process for Industry Guidance, allowing regulators to consider and adopt industry initiatives that will help achieve the desired regulatory outcomes.

5. The CSTO should ensure that the development of a new securities act, and subsequent regulation, not infringe on the current provincial insurance regulation of the distribution of segregated funds.

6. The draft securities act should contain the necessary language that will accommodate advisor incorporation.

7. The CSTO should recognize the need for continued and meaningful provincial involvement in policy development under any new securities regulatory structure.

I. Introduction

Advocis, The Financial Advisors Association of Canada, is the largest and oldest voluntary professional membership association of financial advisors and planners in Canada. Our association was founded in 1906, as the Life Underwriters Association of Canada.

More than ten thousand members of Advocis in Canada provide comprehensive financial planning and investment advice, retirement and estate planning, risk management, employee benefit plans and disability coverage, to millions of Canadian households and businesses. Our members are provincially licensed to sell life and health insurance, mutual funds and other securities. Advocis members are for the most part independent owners and operators of small businesses, entrepreneurs who create thousands of jobs in every community across Canada. Advocis members maintain lasting relationships with their clients based on trust. They help clients, young and old, individuals, families and businesses, set financial goals, manage risks, save consistently and invest prudently.

Advocis members embody professionalism based on education, best practices, and high standards of proficiency and ethics. Advocis promotes the professionalism of financial advisors through:

- Advocis' Code of Professional Conduct;
- guidance on best practices;
- errors and omissions insurance coverage that protects consumers;
- professional designations supported by a comprehensive curriculum and rigorous standards – Advocis' Chartered Live Underwriter (CLU) and Registered Health Underwriter (RHU), and educational support for the attainment of the Certified Financial Planner (CFP); and
- mandatory competency-based continuing education.

Advocis believes that Canadians should have ample access to professional financial advice, products and services and should be able to choose among a diverse range of financial service providers. We also believe that independent-minded, entrepreneurial, small business professional financial advisors provide valuable service to Canadians in delivering professional financial advice, products and services and have a significant place in the financial services sector.

The existing regulatory framework, and the direction in which regulation is being developed, does not favour choice and a diverse range of choice for Canadians and is limiting access to professional financial advisors. The regulatory framework and the compliance burdens that are being imposed are skewed in favour of larger dealer member firms that are able to accommodate increased compliance requirements by virtue of their size and well staffed compliance departments.

Of the large number of financial advisors in Canada, many are self-employed proprietors of small businesses that employ many people in their communities. In addition, a significant number of advisors are employees of mid-to-large sized financial institutions and dealer firms. Professional financial advisors are a vital part of the financial services marketplace and of their communities.

Advocis is not calling for less regulation, but for more appropriate and effective regulation that will protect the public without hampering the ability of professional financial advisors to serve Canadians.

Public policy should recognize the importance of access to affordable professional advice in helping Canadians meet their long-term financial goals.

No one spends more time with the consumer, explaining financial concepts and products, than the financial advisor.

Ensuring that Canadians continue to have access to affordable financial advice that is provided by professional financial advisors will contribute to making Canadians more financially literate and will result in informed financial decisions.

However, financial literacy and financial education are not a substitute for professional financial advice. Consumers should not be expected to serve as their own financial experts; they need access to affordable professional financial advice to help them achieve good financial outcomes and achieve their financial goals over the long term.

II. Principles/Outcomes-based Regulation (PBR) and Proportionate Regulation

Overview:

- The Hockin Report recommends PBR as a new way forward in regulating the Canadian capital markets.

- A full understanding of the PBR process leads to the conclusion that it is a stronger and smarter form of regulation than what currently exists. This conclusion is premised upon PBR being properly implemented by regulators.

- PBR is stronger and smarter because:

    - avoidance of a rule or policy becomes near impossible based on a technical interpretation;
    - avoidance is met with more effective enforcement; and
    - the regulated community has a greater interest and role to play in developing rules and ensuring that rogue industry participants are brought into line as the regulation that is produced through PBR has a stronger market focus and is good business.

- In a PBR environment the idea is for the regulated industry itself to participate in and design the detailed rules and procedures that will permit the standards set by the principles to be achieved.

- Rules designed by market participants are more likely than rules designed by regulators to be successfully implemented in a cost effective manner. This should result in a greater degree of compliance among the regulated community.

- The guiding core regulatory principles that should direct action on the part of regulators, trade associations, and professional bodies are:

- act only in the case of market failure, information asymmetries or matters of consumer protection;
- identify the problem through detailed consultation and analysis; and
- employ PBR responses unless there is clear evidence that absent a prescriptive policy response, harm will be done to consumer or the market.

• The key elements of PBR are:

  - broad-based standards in preference to detailed rules; and
  - outcomes-based regulation, and acceptance of increased responsibility of trade associations and professional bodies in establishing suitable practices to meet the general principles established by the regulator.

Recommendations:

1. **The proposed draft securities act should be principles-based with all rules, instruments and policies developed from a Principles Based Regulation (PBR) platform and focused on achieving the desired regulatory outcomes. PBR should also apply to rules and policies developed by the SROs.**

2. **The draft securities act should stipulate that attention must be paid to proportionate regulation both at the issuer level and the distribution level.**

Analysis:

The shift to PBR in no way hails the end to regulatory oversight, rather, it is a recognition of the regulators' limitations in providing the specialized experience and knowledge that industry can provide, and places increased responsibility on the regulated community itself to provide solutions that are consistent with the general principles established by the regulator.

Advocis supports a regulatory system that is principles-based, especially considering the piling on of rules and regulations that currently exists that fail to reflect the business dynamic that defines investor/advisor relationships.

A principles-based approach to regulation requires regulators to adopt a sound approach to regulation, one based on detailed consultation with industry and individual participants in the capital markets. At the same time capital market participants must take an active interest and participate in the formulation of regulation and rules. In brief, Advocis believes in a principles-based approach to regulation where the proper balance is struck between the use of principles and prescription, and where capital market participants must be proactive and a partner with regulators in achieving a progressive, vibrant and globally competitive marketplace.

The guiding core regulatory principles that should direct action on the part of regulators, and trade and professional associations are: act only in the case of market failures, information asymmetries or matters of consumer protection; identify the problem through detailed consultation and analysis; and employ PBR responses unless there is clear evidence that absent a prescriptive policy response, harm will be done to consumers or the market. It is also critically important that filing requirements allow regulators to gather information that will help them determine if the policy response has properly identified and corrected the identified problem. Built into every policy instrument should be a requirement for a five-year review. If the evidence gathered through the filing requirements indicate that the policy instruments or

confirmed Industry Guidance[1] has not achieved its stated purpose, or has ancillary effects that are harmful or inadvertently restrict market practices, then the policy must be set down for immediate review, or the confirmation withdrawn. The review should consider whether the regulation or confirmed Industry Guidance is justified, needs amendment or should be repealed. In striking the right balance between investor protection and increased market efficiency there is a need on the part of regulators to provide a robust cost/benefit analysis for all proposed rules and regulations. The onus is on regulators to demonstrate that the benefit to investors and markets clearly outweigh the costs of the regulation.

In a PBR environment the idea is for the regulated industry itself to design the detailed rules and procedures that will permit the standards set by the principles to be achieved. To help firms determine how best to meet the expectations under PBR, the FSA, for example, has turned to the regulated sector to provide sector specific guidance. It is expected that such guidance would come from industry associations, professional bodies or groups of firms.

Proportionate Regulation

Within the context of the securities sector, proportionate regulation must mean more than accommodating small issuers listing on the TSX Venture Exchange. It must also address the needs of small business within the distribution channel of the securities sector.

Proportionate regulation recognizes that a one size fits all approach to regulation is detrimental to the market. Indeed, the benefits of proportionate regulation are most easily recognized through analyzing the negative impact of applying the same listing rules to a senior issuer who likely has listings on other foreign exchanges, to start-ups and junior issuers. The effect is to force junior issues to take time away from growing their business to attend to compliance requirements that serve no identifiably useful purpose.

Similarly, the distribution channel for securities should be regulated with an understanding that not all financial advisors are the same, nor do they need to be regulated the same way. A financial advisor who is in an employer/employee relationship with a large financial institution will have compliance support provided by the institution. The compliance in such a case is necessary given that larger financial institution will have regulatory obligations that arise as a result of their roles as broker/dealers, custodian and depositories. Accordingly, compliance heavy rules created by the SROs have little impact on the ability of this group of financial advisors to do business. However, if the same rules are applied to an independent financial advisor, who is an agent of a broker/dealer, the compliance burden must be assumed directly by that financial advisor. In this case there is no centralized compliance department to provide services. This is problematic and demonstrates a failure on the part of the SROs to properly identify where the risk arises in the distribution channel, and accordingly incorrectly over regulates financial advisors to the distinct disadvantage of smaller independent financial advisors. This will have serious negative long term implications for consumers in terms of access to professional financial advice and choice in the marketplace.

A failure to apply proportionate regulation in the securities distribution channel is inappropriately defining the market and hurting consumers. A proportionate approach to regulation must operate not only at the issuer level but at the distribution level as well.

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[1] Industry Guidance is the term used by the UK FSA identifying rules or policies that have originated from industry and have received some level of recognition from the FSA. Industry Guidance is discussed in greater detail in the *Technical Analysis*.

III. Inappropriate SRO Oversight

Overview:

- Financial advisors are inappropriately regulated by the Mutual Fund Dealers Association of Canada (MFDA) and Investment Industry Regulatory Organization of Canada (IIROC) (collectively the, SROs).
    - In relation to investors, financial advisors are intermediaries of information and investment expertise.
    - Intermediation of client assets creates risk through exposing client assets to the possible bad faith or fraud of an intermediary.
    - This risk attracts regulation. Financial advisors are not intermediaries of client assets, therefore the risk associated with the intermediation of a client's assets is not present in the advisor/client relationship.

- The effect of inappropriate regulation of financial advisors places increasingly burdensome compliance requirements on already compliant financial advisors.

- The reliance by the SROs on rules and compliance protocols is easily accommodated by large organizations with dedicated and well staffed compliance departments. It is not easily accommodated by independent owner operators of small businesses.
    - It is costly for an independent owner operator to establish a compliance department, however, advisors can comply with all of the fundamental regulatory obligations under PBR.
    - Time devoted to unnecessary compliance requirements takes the financial advisor away from the attention that should be devoted to realizing the client's long term financial goals.
    - The financial advisor, like most securities registrants, is appropriately held to a high duty of care – *fairness, honesty, and good faith*.

Recommendations:

3. **There needs to be a reexamination of who should be regulating financial advisors. This should include a thorough review of the role of SROs (MFDA and IIROC).**

Analysis:

Financial advisors are inappropriately regulated by the MFDA and IIROC and this is a function of the current regulatory structure, as well as a function of the SROs regulating from a prescriptive platform.

Principles-based, or outcomes-based regulation similar to what exists under provincial insurance regulation and securities regulation in other countries, if adopted in Canada, would lead to the logical conclusion that the MFDA and IIROC should be reviewed to determine how best to incorporate their expertise within the broader context of PBR.

In order to properly regulate the distribution side of the securities sector there are a number of key relationships that are not receiving full or appropriate consideration by the SROs. While all the relationships are related, they are distinct, and they should be regulated to different standards in recognition of their uniqueness. Unfortunately, less than prudent regulation is resulting in the SROs defining the market as opposed to identifying market failures and addressing them.

The proper regulation of the distribution side of the securities sector necessitates an appreciation and understanding of the relationships that exist between the client and financial advisor; financial advisor and dealer; client and dealer; and the role of intermediation.

While the senior regulators and SROs have in statute and rules identified the material difference in the duty of care owed by financial advisors to clients; dealers to clients; financial advisors to dealers; and other intermediaries to clients, the SROs have failed to appreciate the nuances that exist between the different stakeholders in the chain of distribution and focus too rigidly on compliance heavy prescriptive rules that apply across the board. This approach demonstrates a complete lack of attention to proportionate regulation, and is harmful to the market and consumers.[2]

The MFDA and IIROC have an inherent conflict in their structure. They view regulation through the lens of the dealer registered firm operating on an employer/employee basis that brings with it the associated compliance support of the larger institutions.

The SROs have proven that they are not appropriately structured to regulate a diverse distribution sector with both large and small operations present.

IV. Advisor Panel and Increased Role for Trade Associations and Professional Bodies

Overview:

- The CSTO has the opportunity to borrow from the best of other regulators around the world, such as the UK FSA, and learn from their errors. There is a need for small business to be represented in policy development and oversight of the regulator through a statutory requirement to create an Advisor Panel.

- A failure to include an Advisor Panel will set the stage for problems shortly after the implementation of the new regulator as a very vocal and important element of the Canadian capital markets will have been marginalized.

- In a PBR environment the idea is for the regulated industry itself to design the detailed rules and procedures that will permit the standards established in the principles to be achieved.

- Industry Guidance is defined as *information created, developed and freely issued by a person or body, other than the regulator, which is intended to provide guidance from the body concerned to the industry about the provision of the regulation.*

- Industry Guidance is developed by industry for industry.

[2] The inappropriate regulation of financial advisors is discussed in greater detail in the *Technical Analysis*.

Recommendations:

4. **The CSTO should recommend the establishment of an Advisor Panel to ensure that small securities registrants have a clear advisory voice in the development of policy. They should also adopt a process for Industry Guidance, allowing regulators to consider and adopt industry initiatives that will help achieve the desired regulatory outcome.**

Analysis:

Advocis strongly endorses a more focused and inclusive consultation process for the development of rules, instruments, and policies.

It is widely recognized that consultation with a broad array of market participants will result in regulation reflective of the diverse needs of all stakeholders. This translates into improved, less intrusive, and less costly regulation that is more likely to properly identify market failure, result in well crafted responses to these identified failures, and result in a higher degree of stakeholder buy-in. Consequently a higher degree of compliance can be expected.

Advocis believes that the CSTO should take a very close look at the experience of other regulators such as the FSA in developing a statutory requirement for mandatory panels that must be involved in an advisory capacity in the development of policy.

The UK's *Financial Services and Markets Act 2000* (the "FSMA") requires the FSA to consult with both consumers and practitioners. To bring meaning to this provision the FSMA stipulates that the FSA must establish both an independent Practitioner Panel and a Consumer Panel.[3]

Advocis fully endorses the recommendation that the new securities act include a requirement for panels. We urge the CSTO to recognize the inherent problem they will be creating in failing to provide an Advisor Panel, or at the very least a Small Business Panel in addition to an Investor or Consumer Panel.

The experience of regulators in the UK serves as a good example of the problems that will be created in not establishing panels that adequately reflected the composition of the capital markets. Through statute the FSA was required to create a Practitioner Panel and the Consumer Panel. In part, these two bodies monitor the regulator's activities, ensuring that both buyers and sellers of financial products have a voice in the regulatory process.

In 1999 the FSA, in recognizing that they had failed to be inclusive enough in establishing panels, set up the Smaller Business Practitioner Panel to represent the views and interests of smaller registrants. Clearly the FSA recognized that for PBR to operate effectively, the panel process needed to be inclusive of a broader range of registrants. They realized that small registrants were not adequately represented in the original regulatory structure.

In the Canadian context, the CSTO has the opportunity to borrow from the best of the FSA experience and learn from their errors. A failure to include an Advisor Panel, or at the very least a Small Business Panel, the composition of which would include advisors, will simply set the stage for problems shortly after the common regulator commences operation as a very vocal and important element of the Canadian capital markets will have been marginalized.

[3] Please see the *Technical Analysis*, for more details.

Commissioners of the new Common Regulator

If the first priority of securities regulation is investor protection, financial advisors must be recognized as key stakeholders. Yet the securities commissions seem to have a narrow perspective on who should be a Commissioner and what type of background and experience should inform the Commission's decisions. Historically the commissioners have come primarily from corporate issuers and investment dealers or have been securities lawyers from large law firms.

We believe that in addition to the statutory requirement for an Advisor Panel, there should be a statutory requirement identifying the composition of the commissions' board which should include representative from the financial advisor community.

Industry Guidance

Industry Guidance is defined as information created, developed and freely issued by a person or body, other than the regulator, which is intended to provide guidance from the body concerned to the industry about the provision of the regulation.

The CSTO should examine the use of Industry Guidance in the UK as a model that would be well suited to a Canadian securities market operating from a PBR platform. Industry Guidance encourages greater active management on the part of the regulated community. The FSA model has a well established process for industry to directly participate in the policy process.[4] Responsibility for the content of Industry Guidance lies with the provider. The FSA will only confirm Industry Guidance if they are content that it is consistent with their own rules, so that consumer protection will not fall below the standards they require and that it should deliver an improved regulatory outcome. Rules established by regulators should already aim to address an identified market failure and Industry Guidance should help to address the market failure.

The chief benefit of the industry making use of Industry Guidance is that where the developers of such guidance have a better detailed understanding of the sector concerned, a closer fit with commercial good practice should result. In turn, that can bring reduced compliance costs and more efficient delivery of the regulatory benefits that the regulator is seeking to secure.

Following Industry Guidance is voluntary. It is intended to assist registrants meet their regulatory obligations. The FSA is of the view that trade associations, and professional bodies are most likely to be developers of Industry Guidance. They expect the demands and needs of the industry and consumers will drive the take-up of these standards. One of the main points of Industry Guidance is that it is developed by industry, for industry.

Industry Guidance can replace the need for regulators to take regulatory action. If industry takes action to address a concern that regulators have identified with the result that the regulator does not need to make rules, 'implicit recognition' of Industry Guidance could follow. By not making rules the regulator is acknowledging that the industry based solution addresses the issue and therefore firms that follow the industry based solution should meet their regulatory obligations in that area.

[4] Please see a more detailed discussion on Industry Guidance in Appendix "A", *Technical Analysis*.

The FSA acknowledges and embraces the idea that industry may wish to create its own guidance to assist firms and individuals that want more information on the FSA's principles and high level rules. Guidance developed by the industry makes use of the industry's expertise and results in more effective and efficient regulation. PBR envisions organizations such as trade associations and professional bodies playing a significant role in helping the industry develop suitable practices to meet their regulatory obligations.

V. Segregated Funds:

Overview:

- The distribution of segregated funds is appropriately regulated under the provincial insurance regulatory framework.

Recommendations:

5. **The CSTO should ensure that the development of a new securities act, and subsequent regulation, not infringe on the current provincial insurance regulation of the distribution of segregated funds.**

Analysis:

Functions traditionally performed in one sector such as insurance are now undertaken in others, and financial techniques are emerging which combine characteristics of various traditional transactions types. Structured products may be offered in a range of alternative legal 'wrappers' and are offered either as insurance products in the insurance sector, or as security products in the capital markets. Given the increasingly complicated nature of financial products, we have expressed the belief that greater care must be used to ensure the fair and equitable treatment of stakeholders in different sectors.

Segregated funds are subject to three different regulatory regimes, administered by two different levels of government for different purposes: by federal legislation/regulation as it pertains to solvency and corporate governance of life insurance companies; by provincial securities legislation/regulation as it pertains to the underlying fund; and by provincial insurance legislation/regulation as it applies to market distribution, consumer protection and generally applicable elements of all life insurance contracts. We believe that care should be exercised to ensure that a system that is working well is not disturbed.

The marketing and distribution of segregated funds is currently subject to the legislative and regulatory requirements for life insurance products. We believe these requirements have proven effective to protect consumers. While the current regulatory structure does not currently include requirements specific to segregated funds or identify segregated funds as being distinct and containing elements which extend beyond those of traditional insurance products, we believe that the existing regulatory framework for life insurance products is capable of ensuring that consumers receive appropriate disclosure and are protected.

Segregated funds, like other life insurance products are subject to the provisions in provincial insurance acts and guiding principles set out by the Joint Forum in their 2005 document *Principles and Practices for the Sale of Products and Services in the Financial Sector* which was endorsed by all provincial insurance and securities regulators across Canada. Like all other life insurance products, the marketing and sale of segregated funds is subject to the three key

principles-based recommendations established by the Industry Practices Review Committee (IPRC) of the Canadian Council of Insurance Regulators (CCIR) and the Canadian Insurance Services Regulatory Organizations (CISRO) in 2006:

1. priority of client's interest – an insurance intermediary (broker or agent) must place the interests of insurance policyholders and prospective purchasers ahead of his or her own interests;
2. disclosure of conflicts or potential conflicts of interest – consumers must receive disclosure of any actual or potential conflicts of interest associated with a transaction or recommendation; and
3. product suitability – the recommended product must be suitable to the needs of the consumer.

All life insurance agents have to adhere to the above-noted three principles for each recommendation made to a client.

In addition, agents are required to follow the steps set out in the Canadian Life and Health Insurance Association (CLHIA) Guidelines on Individual Variable Insurance Contracts (IVICs) which has been endorsed by the CCIR. These steps include delivery of the Information Folder and will include compliance with revised point of sale requirements as set out by the Joint Forum in *Proposed Framework 81-406: Point of sale disclosure for mutual funds and segregated funds* (the, Framework). The CCIR is in the process of implementing the Framework by establishing revised point of sale disclosure standards for segregated funds, which include the delivery of the Key Facts and Fund Facts point of sale documents to clients. The attention by insurance regulators to principles is what industry trusts the CSTO will be recommending on the securities side.

In our view, the existing regulatory framework for segregated funds sales is appropriate and can deal effectively with any emerging issues.

The CSTO must ensure that in developing a new securities act and regulator that the current regulation of the distribution of segregated funds remains intact absent compelling evidence of a problem, and evidence that an identified problem could not be properly addressed by the insurance regulators and industry.

VI. Incorporation

Overview:

- The CSTO in drafting a new securities act has the opportunity to address the long standing issue of advisor incorporation.

- What prevents advisors from incorporating and sharing in the benefits that arise from incorporation is:
    - MFDA Rule 2.4.1; and
    - the registration requirement limitations in securities legislation.

- The current splintered nature of securities regulation in Canada has made a harmonized solution to this problem unnecessarily difficult. In developing a new securities act for a common securities regulator the opportunity to address this issue is now.

- To successfully address the incorporation issue the CSTO could adopt the definitions provided in the *2004 British Columbia Securities Act*

- Further, the CSTO would need to address the registration requirements section of any proposed securities act and adopt wording that will exempt corporations from the registration requirements subject to specific conditions that will ensure continued consumer protection.

Recommendations:

6. **The draft securities act should contain the necessary language that will accommodate advisor incorporation.**

Analysis:

In drafting the new securities act, the CSTO has the opportunity to address the long standing issue of advisor incorporation. All jurisdictions that are working with the CSTO towards establishing a new common regulator have issued, or are in the process of issuing, exemption orders suppressing MFDA Rule 2.4.1 that precludes MFDA Members from providing any form of remuneration for services provided other than to the individual Approved Person.

The MFDA has an amendment to Rule 2.4.1 pending that would allow remuneration to be paid to a corporation controlled by a financial advisor. There is near unanimous agreement that this long standing irritant should be addressed

To successfully address the incorporation issue the CSTO could adopt the definitions provided by the *2004 British Columbia Securities Act*. Advocis is of the opinion that this would provide the necessary definitions to ensure that a corporation can be an 'adviser.'

Further, the CSTO must ensure that the registration requirements section of their proposed securities act adopts wording that would remove the need for a corporation to be a registrant in the limited situation where a registered advisor is running their business through the corporation. The registration requirements section of the act would also require wording that mirrors the conditions contained in a number of exemption orders that provide that the advisor corporation need not be a registrant. The conditions to the orders that provide that the corporation need not be a registrant ensure that the registered advisor and/or registered mutual fund dealer cannot hide behind the corporate veil. This means that the investor (consumer) retains all legal recourse against the advisor and dealer regardless of the fact that the business is being carried on through a corporation.[5]

VII. Provincial Involvement in New Regulatory Structure:

Overview:

- Great care must be taken when altering the existing securities regulatory structure to ensure that we do not marginalize the views of participants.

- Regional issues and concerns must have a clear voice and avenue to be heard.

[5] Further details of the required changes can be found in the *Technical Analysis*.

- Advocis strongly urges the CSTO to preserve the regional representation in policy development under the new common regulator through ensuring that the provinces continue to play a meaningful role.

Recommendation:

7. **The CSTO should recognize the need for continued and meaningful provincial involvement in policy development under any new securities regulatory structure.**

Analysis:

A clear benefit of the passport system of securities regulation is that participants in the capital markets have the opportunity to be heard and influence policy. In the event that a market participant is unable to access the appropriate persons in any one jurisdiction to voice their views or concerns about existing or proposed policy, they have an opportunity to influence final decisions through finding a jurisdiction(s) that share the same view and will champion that view within the Canadian Securities Administrators (CSA).

Accordingly, great care must be taken in altering securities regulation to ensure that stakeholder views are not marginalized due to the more centralized structure of a common securities regulator. While the existing scheme of securities regulation in Canada has substantial shortcomings, it does allow a range of voices and opinions to be heard. In the development of a common securities regulator every effort should be made to ensure open and meaningful dialogue between capital market participants and the regulator is promoted.

We believe the successful model for securities regulation in Canada will be guided by the following principles: a mechanism whereby regional issues and concerns are voiced and taken into consideration; openness and full consideration of all opinions; access to the policy process for all market participants; access to decision makers and clear paths of communication; a principles-based approach to regulation adopted by the senior regulator and SROs; minimization of redundancies, and fully harmonized legislation and regulation; an efficient and effective investigative, enforcement and adjudicative process; and a cost efficient approach to capital market regulation.

Advocis strongly urges the CSTO to preserve the regional representation in policy development under the new common regulator through ensuring that the provinces continue to play an important role.

APPENDIX “A”
Technical Analysis

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The appendix will focus on four elements discussed in the submission and provide a more detailed analysis.

1. The relationships between the client, financial advisor and dealer firm.
2. PBR and Industry Guidance in promoting the increased participation of trade associations and professional bodies.
3. Advisor Panel as a statutory requirement. And
4. Incorporation for financial advisors.

1. The Relationships Between the Client, Financial Advisor, and Dealer Firm

Introduction

The separation that exists between dealing with client information, and dealing with client assets does not appear to be well understood or clearly articulated by the SROs. As a result, financial advisors are inappropriately caught by regulation that is more appropriately designed to deal with the personal property issues that arise through the intermediation of intangible economic interests in securities.

Financial advisors play two distinct but related roles in the securities sector. In the first, they are agents of the dealer firm working in furtherance of a trade in securities. However, financial advisors also have a more direct relationship with their clients in helping then achieve their long term financial goals.

Overview:

- Financial advisors are inappropriately regulated by the Mutual Fund Dealers Association of Canada (MFDA) and Investment Industry Regulatory Organization of Canada (IIROC).
- In relation to investors, financial advisors are intermediaries of information and investment expertise. Financial advisors are not intermediaries of client assets.
- In relation to dealers, financial advisors are either employees or agents of the dealer in providing client information and trade requests necessary to complete the contract of purchase and sale of securities.

Brief Commentary:

The current regulatory structure surrounding the distribution of securities has developed with a clear focus on the dealer firm registrant and the employer/employee model. Consequentially, independent advisors are monitored by MFDA dealer firms who are instructed to ensure that their 'agents' adhere to MFDA rules and regulations,[6] and conduct their business in a

[6] MFDA Rule 1.1.5 *Agents* provides that, "[a] Member may conduct its business by Approved Persons retained or contracted by it as agents provided that, …(b) the member shall be responsible for, **and shall supervise, the conduct of the agent in respect of the business including compliance with applicable legislation and the By-laws and Rules**; (c) the Member shall be liable to third parties (including clients) for the acts and omissions of the agent relating to the Member's business." [emphasis added]

professional manner.[7] These rules and regulations are designed to address the risks associated with the role the dealer firm plays as intermediary in the purchase, sale, holding and transfer of securities. The rules and regulations are not crafted to accommodate the client/financial advisor relationships that are central to the independent channel.

Our analysis focuses on the proprietary aspects of securities. It argues that the computerization that allows for immobilization, dematerialization, electronic custody and settlement has fundamentally altered the legal nature of assets beneficially owned by investors. Further, we believe that the fundamental change in the legal nature of securities has impacted how dealers are regulated to address the status-based fiduciary obligations they assume in their role as trustee in the intermediaries of the clients' assets.[8]

The global trend is for all but a very few securities to be immobilized or dematerialized. Indeed, mutual funds are fully dematerialized. Immobilization and dematerialization affect the nature of property and how it is held which has profound implications for the operation of the securities market. In a dematerialized and immobilized environment securities are defined as intangible economic interests in securities, and trust law becomes paramount with individuals who hold or handle a client's economic interests in securities becoming trustees.[9]

It is important to recognize that what the financial advisor deals with is information. Accordingly, we term the financial advisor as the intermediary of information and not personal property. The fact that the financial advisor is not part of the intermediation of securities is important in our analysis as we believe that rules created by the SROs that are properly intended to protect client assets are receiving very broad interpretation by the SROs resulting in financial advisors being held to a duty of care that is intended for other intermediaries who handle a client's economic interest in securities and therefore, under trust law, owe fiduciary obligations to their clients.

A proper review of the distribution channel for securities must be undertaken with the understanding that the ultimate findings may result in amendments to the recently implemented NI 31-103, *Registration Requirements and Exemptions,* and the possible addition of a new registration category for financial advisors. Further, the review must consider who should have regulatory oversight of financial advisors. The issue becomes whether the current SROs are appropriately structured to regulate financial advisors, if a new SRO is required, or whether under the new common regulator the expertise housed in the SROs should be redistributed within the new common regulator.

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[7] MFDA Rule 1.2.5, *Reporting Requirements, Approved Person Reporting,* (b) states that, [e]very Approved Person must report to the Member such information, in a manner and within such period of time, as may be prescribed by the Corporation from time to time relating to complaints, criminal, civil and other legal proceedings, regulatory proceedings, arbitrations, contraventions and potential contraventions of legal and regulatory requirements, disciplinary action by regulatory bodies, settlements with and compensation paid to clients, registration or licensing by any regulatory body, bankruptcies, insolvencies, garnishments and related events. (c) *Failure to Report*, [a] Member shall be liable for and pay to the Corporation levies or assessments in the amount prescribed from time to time by the Corporation for the failure of the … Approved Person to report any information required to be reported …".

[8] The impact of economic interests in securities on the structure of the securities sector, including the distribution channel are the focus of a number of working papers by Edward Skwarek B.A., LL.B., LL.M. (specialist in corporate and securities law). The ideas contained in this paper are further developed in these working papers.

[9] A trustee is a status-based fiduciary. A trust relationship can either be formally established under a trust indenture or declaration of trust, or in the absence of any constating document the courts can determine that there was the intention or need for a trust to exist and the trust relationship will arise under a constructive trust.

Recommendations:

We urge the CSTO to strongly recommend that the first order of business for the new common regulator be the striking of a committee to examine what options should be considered in recasting the rules as they apply to the various business relationships that exist in the distribution of securities.

We believe that Canada is in a position to be the global leader in establishing the most responsive and dynamic securities distribution system in the world. To this end we recommend that the committee consider the following questions as a starting point in their analysis.

- Should financial advisors be limited by the current system that requires that they be employees or agents of the dealer firm or is this unnecessarily limiting?
- Is it possible for financial advisors to be more reasonably and appropriately regulated outside of the current SROs?
- Are there opportunities to be realized by consumers through allowing financial advisors greater latitude in establishing business relationships with other securities registrants?
- Are independent financial advisors a positive force in the securities industry, and can they survive and flourish under the current regulatory framework?
- What are the benefits to consumers and industry that can be realized through the rethinking and reordering of the relationship that starts with the consumer and financial advisor, and works its way to the dealer and ultimately the product developer? Are there other avenues available that may represent new market opportunities, consumer choice and investment opportunity, without compromising consumer protection and market integrity?
- Is the current structure outdated and unnecessarily skewed in favour of dealer registered firms and institutions, and does this have negative implications for market innovation, competition, and consumer interests?
- Can the government's public policy goal of greater individual financial self reliance be furthered through changes in the distribution channel of securities?

I. *Nature of Intangible interests in Securities*

Introduction:

Economic interests in securities[10] are created through the immobilization and dematerialization of securities. Economic interests in securities define how securities are held and transferred in the modern securities markets.

Overview:

- Economic interests in securities are intangible, fungible, and unallocated.

- Intangible securities must be held indirectly.

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[10] The term 'economic interest in securities' can be used interchangeably with the term 'interests in securities'. The *Draft Canadian Securities Act* (DCSA) defines an economics interest in security as, "(a) a right to receive or the opportunity to participate in a reward, benefit or return from a security; or (b) an exposure to a loss or a risk of loss in respect of a security." The Ontario *Securities Transfer Act 2006*, references the *Personal Property Security Act* which defines securities interest as, "an interest in personal property that secures payment or performance of an obligation …".

- Indirectly held interests in securities can only exist through intermediation, and can only be held in a trust structure.

- The trusteeship is the most intense form of fiduciary[11] relationships.[12]

Brief Commentary:

Immobilization requires the use of securities in paper form and the use of depositories which are linked to a settlement system. The securities are termed immobilized as the depository holds the securities at all times.

Dematerialization is distinct from immobilization as it dispenses with paper securities altogether. In a dematerialized system the securities exist only as electronic records.

The legal impact of dematerialization in relation to bearer and registered securities is unique. Registered securities are intangible assets. The physical certificate issued in respect of a registered security merely evidences, and does not constitute, the security.[13] Accordingly, the elimination of paper certificates and transfer forms in relation to registered securities is merely a procedural matter, and does not fundamentally alter the legal nature of the security which is intangible in both dematerialized and non-dematerialized form.

With bearer securities the impact is greater as they are tangible instruments. Possession of bearer instruments does not merely evidence ownership, rather, through the operation of law it constitutes ownership. Therefore with dematerialization, physical instruments are replaced by electronic records. Tangible assets are replaced by intangibles.

The global trend is for all but a very few securities to be immobilized or dematerialized. Indeed, mutual funds are fully dematerialized. Immobilization and dematerialization affect the nature of property and how it is held which has profound implications for the operation of the securities market. In a dematerialized and immobilized environment securities are defined as intangible economic interests in securities, and trust law becomes paramount with individuals who hold or handle a client's economic interests in securities becoming trustees.[14]

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[11] Fiduciary duty is a difficult area of law. "This area of law is highly complex, poorly delimited, and in a state of flux", *Law Commission Consultation Paper* (may 1992) 26, 27. It has been suggested that 'the fiduciary relationship is a concept in search of a principle': Sir Anthony Mason, *Themes and Prospects* in P D Finn *Essays in Equity* (1985), Quoted at 54, 55. See also *Bristol and West Building Society v Mothew* [1998] Ch 1, per Millett LJ at 16: 'this branch of the law has become bedeviled by unthinking resort to verbal formulae'.

[12] P D Finn.

[13] Registration is required to transfer legal title: *Societe Generale de Paris v Walker* (1895) 11 App Cas 20. An equitable interest in shares may be delivered by a trust or charge, without reregistration. In order to achieve registration the transferee must (in the case of registered securities in traditional form) submit to the registrar the certificate of the transferor together with a transfer form made out in the transferee's favour, and executed by the transferor. In due course the registrar replaces the name of the transferor with the transferee, cancels the transferor's certificate and issues a new certificate in favour of the transferee.

[14] Please see footnote 9.

II. *Role of the Dealer Firm*

Introduction:

While direct contact with the investor rests with the financial advisor, the dealer firm is directly involved in the intermediation of client assets and executes the client instructions for the purchase, sale, and transfer of securities.

With economic interests in securities increasingly dominating the securities markets the role of the dealer as an intermediary of client assets requires significant regulatory oversight.

Overview:

- Members of the MFDA and IIROC (collectively, SROs) are intermediaries of client assets, and they also represent the only means by which an investor can purchase mutual funds or other securities.

- Intermediation of client assets creates risk, through exposing client assets to the possibility of bad faith or fraud of an intermediary. This attracts regulation.

- Client assets include cash, securities and economic interests in securities (i.e. personal property - chose in possession and chose in action).

- Economic interests in securities (chose in action) can only exist through intermediation which is increasingly important in the securities sector. [15]

    - The only legal structure available to hold intermediated economic interests in securities is a trust.
    - A trust creates a fiduciary duty. The duty is owed to the beneficiary by the trustee.[16]
    - Trustees owe fiduciary obligations to their clients as a categorical matter.

- Only a dealer can complete the contract of purchase or sale of a security for a client, not the financial advisors.

    - This means that the dealer is the agent for the client, who is the principal in the contract of purchase or sale.
    - With respect to the purchase, sale and transfer of assets the agent (dealer) owes a fiduciary duty to the client in carrying out the instructions.

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[15] CDS Annual Report 2008, states that CDS has a target date of 2014 for full dematerialization. "[D]emand within the industry have encouraged CDS to proceed with its initiative and efforts to achieve dematerialization." This has no impact on the existence of fiduciary obligations, rather, it deals with how the obligation will arise. In the case where there are physical assets, the law of bailment has in practice applied, whereas, when the property is intangible, trust law must apply.

[16] As all mutual funds are dematerialized and most other securities are immobilized or dematerialized, they are intangible. Intangible property can only exist through intermediation. As there is no property capable of possession, trust law governs the relationship between the intermediary (as trustee) and the client (as beneficial owner).

- In examining the roles of the dealer in holding and handling client assets, and carrying out the instructions of purchase, sale, and transfer, both the trust and agency relationships establish a fiduciary duty that is status-based.[17]
    - In the first instance through a trustee/beneficiary relationship with the dealer being trustee.
    - In the second instance with the investor as principal and the dealer as agent in completing the purchase, sale and transfer of the mutual fund or other securities for the investor.

Brief Commentary:

The legal concept of a trust is central to the operation of the distribution model for securities.[18] The regulatory response to the risks inherent when beneficial ownership and title to securities are permanently severed is meant to address the unforeseen risk that is present when the dealer firm assumes the role of intermediary in the purchase, sale, holding and transferring of securities.

The fundamental change in the legal nature of securities within a immobilized and dematerialized system results in the dealer firm assuming the role of trustee in relation to the clients economic interests in securities. As a result the dealer is a status-based fiduciary.

III. ***Financial Advisors and Dealer Relationship***

Introduction:

SRO rules state that a financial advisor is either an employee or agent of the dealer, with the dealer assuming regulatory oversight of the advisor on behalf of the SRO.

Overview:

- A financial advisor's business relationship with the dealer is characterized as either employee/employer, or principal/agent. [19]

- When working on behalf of the dealer (the principal), the financial advisor is the agent. The agent's actions in relation to the Member's business will bind the principal, holding the principal accountable to a third party client.[20]

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[17] Status-based fiduciaries include people who, by virtue of their involvement in certain relationships are considered, without further inquiry, to be fiduciaries. Such relationships include those between trustee-beneficiary, solicitor-client, and agent-principle. – Law Commission Consultation Paper, *Fiduciary Duties and Regulatory Rules* (May 1992) p 27. Trusteeship is the most intense form of fiduciary relationship. – *Fiduciary Duties and Regulatory Rules*, p 63. It is however important to note that not all duties of a fiduciary are fiduciary duties, and a fiduciary standard does not affect all aspects of the commercial relationship.

[18] In fact the concept of a trust is central to the operation of a global securities markets dependent on immobilized and dematerialized interest in securities. For the purpose of our analysis we are looking specifically at the distribution market for securities in Canada.

[19] MFDA Rule 1.1 *Business Structures*, states that no Member or Approved Person in respect of a Member shall not, directly or indirectly, engage in any securities related business except in accordance with the following … (c) the relationship between the Member and any person conducting securities related business on account of the Member is that of: (i) an **employer and employee**, (ii) a **principal and agent**, in compliance with Rule 1.1.5 or (iii) an **introducing dealer and carrying dealer** … . [emphasis added]

- Oversight of financial advisors by dealer member firms, and indirectly by the SROs, has resulted in complacency within the securities distribution model.

Brief Commentary:

It is important to recognize that what the financial advisor deals with is information. Accordingly, we term the financial advisor as the intermediary of information and not personal property. The fact that the financial advisor is not part of the intermediation of securities is important in our analysis as we believe that rules created by the SROs, that are properly intended to protect client assets, are receiving a very broad interpretation resulting in financial advisors being held to a duty of care that is intended for intermediaries of economic interests in securities.

The result has been to limit the activities of the financial advisor and subject them to the oversight of the of the dealer firm acting as proxy for the SRO. The SROs' regulatory focus is to address the risks that are inherent in the relationship between the dealer and the investor. The rules created, and interpreted by the SROs demonstrate a lack of understanding of the role played by the financial advisors. This is to be expected given the remoteness of the relationship that exists between the SROs and the financial advisor.

The dealer firm has little incentive to question a regulatory structure that captures and limits the financial advisor, as the advisor is the source that generates revenue for the dealer.

IV. *Financial Advisor and Client Relationship*

Introduction:

Financial advisors play two distinct but related roles in the securities sector. In the first, they are agents[21] of the dealer firm working in furtherance of a trade in securities. However, financial advisors also have a more direct relationship with their clients in helping them achieve their long term financial goals.

Overview:

- Financial advisors act as intermediaries in the movement of information and not property. They provide investment information and advice to their clients, and also gather and transfer information required under securities law from the investor to the dealer firm.[22]

- Securities law and regulation establish a duty of care owed by the financial advisor to their client. This is not a full fiduciary obligation.[23]

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[20] MFDA Rule 1.1.5, states that a Member shall (c), "be liable to third parties (including clients) for the acts and omissions of the agent relating to the Member's business."
[21] Please see footnote 19. The advisor as agent will gather the necessary KYC and suitability information for the dealer firm. However, advisors in developing their business relationship with clients go beyond the requirements setout in the rules as doing so is good business. Advisors believe that a reevaluation of options and registration is necessary in order to have the distribution side of securities regulation properly develop for the benefit of the consumer.
[22] National Instrument 31-103 and MFDA Rules 2.1 and 2.2 stipulate what information must be provided to the MFDA Member firm for the purposes of the purchase or sale of securities.

- In equity and based on the specific facts of a given case, the courts may, in the interest of justice find that a fiduciary duty exists between the financial advisor and the client.[24]

Brief Commentary:

A professional financial advisor is an expert who gathers relevant information regarding the client's financial situation, and helps establish financial goals and a road map to achieve these goals. The advisor's business is based on using his knowledge and research and gathering information about the client in order to make sound recommendations from among the ever increasing number of financial products that are available. The financial advisor will use the information gathered about a client and weigh it against investment options and products to find the appropriate products for a particular client and then present these to the client for his consideration. To this point in the relationship the financial advisor should be viewed as operating independently and not as the agent of any particular dealer. It is at the point where the financial advisor identifies one or a number of products that he feels is suited to his client's needs, and the client accepts the recommendation and instructs the financial advisor to communicate his intent to purchase the securities through the dealer firm that the financial advisor also assumes the role of agent for the dealer in the execution of the trade.[25]

V. *The Problem*

Introduction:

The current regulation of the distribution channel for securities is not properly identifying where unforeseen risks to client assets are arising. Accordingly, the SROs cannot provide the appropriate regulatory responses to address these risks. As a consequence of misdirected regulatory responses, independent financial advisors are being inappropriately regulated.

Overview:

- SROs are not appropriately managing all of the market relationships that exist between:

    - dealer and client;
    - financial advisor and client; and
    - dealer and financial advisor.

- SRO rules are properly designed to address the risk clients are exposed to when their assets are held in trust[26] or managed by the dealer firm. The trust structure establishes a fiduciary duty with respect to the proper handling, use and protection of client assets. However,

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[23] The level of trust that a client places in most securities registrants does not establish a fiduciary standard, and securities law has intentionally set a common law duty of care of fairness, honesty and good faith.
[24] This would be a fact-based fiduciary relationship. Here the courts have not limited fiduciary relationships to those presumed as a matter of law. They can arise ad hoc because in the circumstances of the relationship the requisite trust and vulnerability has in fact been obtained, or given.
[25] Prior to a trade in securities taking place specific information listed in National Instrument 31-103 and picked up again in MFDA Rule 2.1 and 2.2 must be gathered.
[26] Held directly by the dealer or where the dealer is acting in the capacity as agent for the trustee.

- too often SRO rules focus on the fiduciary standard without giving proper consideration to other business relationships that exist in the intermediation of information and investment advice. These activities exist outside of the status-based fiduciary obligation that is present where client assets are involved.
- There is no incentive for the SRO to properly balance the many related but distinct business relationships that exist in the distribution channel for securities.
- SRO members are able to accommodate increased compliance requirements, whether reasonable for the whole industry or not, by virtue of their size and well staffed compliance departments.
- A compliance standard that does not adopt a proportionate approach and applies to all equally without proper consideration of the differences in scale may not be easily accommodated by independent owner operators of small businesses.
- Time devoted to unnecessary compliance requirements takes the financial advisor away from the attention that should be devote to achieving the clients' financial goals – financial security and increased self reliance.
- It is costly for an independent owner operator to establish a compliance department and to implement the same kind of approach to compliance that makes sense for large firms.
- The financial advisor is held to a high duty of care, fairness, honesty, and good faith,[27] but SRO rules are inappropriately resulting in financial advisors being required to indirectly assume fiduciary obligations. [28]

[27] The standard of conduct stipulated in MFDA Rule 2.1.1, *Standard of Conduct*, is the same as what is required by senior regulators under securities law. Rule 2.1.1 states that, "[e]ach Member and each Approved Person of a Member shall (a) **deal fairly, honestly and in good faith with its clients**; (b) observe high standards of ethics and conduct in the transaction of business; (c) not engage in any business conduct or practices which is unbecoming or detrimental to the public interest; and (d) be of such character and business repute and have such experience and training as is consistent with the standards described in this Rule 2.1.1, or as may be prescribed by the Corporation." [emphasis added] The problem arises through the MFDA interpretation of this rule. They impart a fiduciary standard which inappropriately limits legitimate activities of registrants.

[28] A prime example is the MFDA's approach with respect to referral arrangements. MFDA Rule 2.4.2 defines a referral arrangement as "an arrangement whereby a Member is paid or pays a fee … for the referral of a client to or from another person." It is reasonable for the MFDA to require that the MFDA Member ensure that potential conflict is addressed through the exercise of responsible business judgment. However, MFDA MR-0030 requires that business judgment is to be influenced, "only by the best interests of the client." This is to establish a fiduciary standard. This also, in the mind of the MFDA, lends credibility to the requirements that referral arrangements are only between a Member. It also leads to the expressed view of the MFDA that financial advisors cannot enter into referral arrangements with other securities registrants. This is a clear example of how the inappropriate application, or the extension of fiduciary duty by a regulator has the effect of defining the distribution market with no sound basis for doing so.

Requiring registrants to act in a client's best interest is to establish a fiduciary standard. Through legislation and regulation the standard has, in most cases, been purposely set for registrants to a lower level than a fiduciary standard. This has been done for commercial purposes. Requiring all registrants in all circumstances to operate from a fiduciary standard is simply unreasonable. Great restraint should be exercised by a regulator in expanding the scope of fiduciary duties where business practices have been established and accepted in dealing with conflicts. Absent a strict fiduciary standard, conflicts are allowed to exist. Conflicts are successfully addressed through appropriate disclosure. Such an approach allows the market and its participants to find solutions to market failures, and maintain the entrepreneurial spirit that defines the capital markets without undue risk to the client. The unilateral action of a regulator such as the MFDA, in expanding the scope of the fiduciary standard will define the distribution market in Canada.

  - The interpretation of rules by the MFDA has the effect of extending fiduciary obligations beyond what is required to properly address the risk of unforeseen loss by an investor.

- Therefore, financial advisors are currently inappropriately regulated under the SRO model.

Brief Commentary:

The SROs are inappropriately structured to regulate independent financial advisors. Under the current system, the oversight of financial advisors is delegated to the dealer firms. The SROs deal at arms length with the advisor.

The main focus of the SROs is to institute rules and policies that ensure that their members are dealing appropriately with the client and client assets. As the financial advisor is not a party to the intermediation of client assets, the concerns that the SROs may have in relation to the conduct of the advisor cannot be reasonably traced to the personal property rights of the client.

Given the arms length relationship of the regulator to financial advisors, it is not surprising that rules and regulations are developed without due consideration for their impact on advisors and their business. A consequence of this arms length approach to regulation is the application of rules and policies that do not appear to be addressing an identified problem.

Commentary:

At the most fundamental level, finance and investments are a system of risk transfer. The function of law and regulation is to permit risks to be transferred from protection buyer to risk taker, to circulate amongst risk takers in the markets, and to ensure that the risk is appropriately managed. While risk is accepted by both institutional and average individual investor, the exposure of the risk taker may result in unforeseen loss. It is the unforeseen loss that attracts increasing degrees of regulation. Securities law and regulation are not intended to remove risk, rather they are intended to ensure that clients are treated fairly and to manage the risk of loss resulting from unforeseen risk.

With a move to full dematerialization the focus will increasingly be on trust law issues and not issues related to physical possession.[29] This is a significant change and is the result of the new risk associated with economics interests in securities where the investor never holds title to his Investment. The custody of securities has long predated the development of electronic settlement systems, and the custodian of bearer securities has traditionally been categorized as bailee. The essence of bailment is the delivery of possession without the delivery of title. Thus the bailee acquires possession of the bailed assets, while the bailor retains title to them. However, because bailment is based on possession, it can only apply to tangible assets. Economic interests in securities as intangible assets cannot be the subject of bailment. With economic interests in securities, title resides with an intermediary and never with the beneficial owner. This is why trust law plays such an important role in addressing the unforeseen risk the client is exposed to when they cannot hold title to their securities. A trust sets the highest fiduciary standard and provides increased protection to the client. However, the protection provided by a trust will never be as strong as what can be achieved in a system based on possession.

[29] Actions will be based on chose in action and not chose in possession.

In the Canadian securities distribution model, the risks associated with intangible personal property rights are regulated by the SROs.[30] The SROs have established rules to address unforeseen risk, but are interpreting their rules too broadly, and are inappropriately extending the fiduciary obligations that arise under a trust to financial advisors who are not involved in the handling of client assets and represent no threat to their safe keeping.

The SRO regulation of risk in the distribution model for securities in Canada is not well focused. As a result we have a system that is dealer centric. This needs to be addressed.

The Nature of Intangible Interests in Securities

No event has had a greater impact on the securities sector than the global move to immobilized and dematerialized securities. The impact has changed how securities are created at the issuer level, the increasingly novel nature of products being developed, and their impact on every stage of the intermediation of the asset including the distribution level. The mutual fund sector is already fully dematerialized with the intent being that all securities will be either immobilized or dematerialized in the near future. This means that interests in securities as distinct from bearer securities and other forms of tangible personal property are having a profound impact on how securities are regulated.

Immobilized and dematerialized securities give rise to intangible personal property[31] that is incapable of possession, and can only exist through intermediation[32]and held in a trust structure.[33] By necessity, legal and beneficial ownership are permanently severed with the client only capable of enjoying the economic benefits that flow from his securities. The client is incapable of taking possession of his asset. The trust structure imposes a status-based fiduciary obligation on the intermediary and serves to protect the beneficial owner from the possible bad faith or fraud of the intermediary.[34] The ring-fencing of the client assets that results from the legal trust provides the added benefit of protecting the client from the credit risk of the intermediary.

Accordingly the legal elements of trust law are increasingly important in the regulation of the intermediation of economic interests in securities.

The Regulatory Response to Risks Associated with Intangible Interests in Securities

The MFDA and IIROC establish regulations, policies, and procedures for the intermediation of client assets to address the unforeseen loss that a client may suffer through the actions of the

[30] Certainly the senior regulators establish rules and policies, but in the context of the financial advisor, it is the SROs and their Members who deal with these issues.
[31] The use of the term intangible in relation to property is well understood in the securities sector and is defined in the Ontario *Personal Property Security Act* as meaning, 'all personal property, including chose in action, that is not goods, chattel paper, documents of title, investments, money or investment property.'
[32] Client assets can be tangibles, such as bearer bonds, or intangibles such as economic interests in securities. The distinguishing factor at law is that for tangibles a client can hold and protect their personal property through taking possession of it, they are 'chose in possession' or ' chattels'. In the case of intangible personal property the client cannot take physical possession and the personal property only exists through intermediation. The client's rights are to an economic interest which can be understood as an obligation. An obligation can only be enforced or protected through an action 'chose in action'.
[33] Accordingly, trust law plays a very important role in the intermediation of securities and is a central factor in MFDA Rules 3 and 4.
[34] Trustee/beneficiary.

dealer, third party trustees, or any other party that may take custody or control of the client assets.[35] While the risk being addressed does not extend to the actions of financial advisor, the development of regulation and the interpretation of rules by the SROs and their Members fail to take this into account resulting in over regulation of financial advisors, limitations on the distribution channel, and the distortion of the distribution market.[36]

Role of the Independent Financial Advisor

Financial advisors play two distinct but related roles in the securities sector. In the first, they are agents[37] of the dealer firm working in furtherance of a trade in securities. However, financial advisors also have a more direct relationship with their clients in helping them achieve their long-term financial goals.

A professional financial advisor is an expert who gathers relevant information regarding the client's financial situation, and helps establish financial goals and a road map to achieve these goals. The advisor's business is based on using his knowledge and research and gathering information about the client in order to make sound recommendations from among the ever increasing number of financial products that are available. The financial advisor will use the information gathered about a client and weigh it against investment options and products to find the appropriate products for a particular client. The advisor will then present the options to the client for his consideration. To this point in the relationship the financial advisor should be viewed as operating independently and not as the agent of any particular dealer. It is at the point where the financial advisor identifies one or a number of products that he feels is suited to his client's needs, and the client accepts the recommendation and instructs the financial advisor to communicate his intent to purchase the securities through the dealer firm that the financial advisor also assumes the role of agent for the dealer in the execution of the trade.[38]

Unfortunately, the bifurcated role assumed by the advisor - as Approved Person or agent of the dealer, and as an independent financial advisor to the client – is not accommodated by SRO rules that are premised on the advisor being solely an exclusive agent to or employee of the dealer firm.

Duty of Care, and Fiduciary Duty

A duty of care can arise under statute, or judicial judgment.[39] When regulators or legislators establish standards of conduct, this is typically referred to as a statutory 'duty or care'.[40] A statutory or regulatory requirement that establishes the expectations that the trusted individual owes to the source of the trust is the 'duty of care'. As the duty arises at common law (in statute), the regulators and not the courts have the authority to set the standards that they feel need to be achieved to ensure consumer protection and effective and efficient commercial

[35] See MFDA MR-0051, and MR-0058 for example.
[36] It creates a moral hazard that results in less competition which is ultimately hurting the consumer.
[37] Please see footnote 21.
[38] Please see footnote 25.
[39] Historically the courts were not unified as they are today but were divided into the courts of common law and the courts of equity. In a situations where a plaintiff had no standing in law or 'at common law', but was nevertheless aggrieved, they would go to the court of equity to plead their case. If the court of equity felt that an injustice would result from inaction they would make a judgment in equity – fairness was the yard stick.
[40] Please see footnotes 27, and 42.

practices. Both of these concerns are major factors in achieving a properly functioning capital market.

The balancing of consumer protection and commercial practices are particularly important in the context of the complex commercial relationships that exist in the securities sector. As judges who pronounce on the content of fiduciary duties in particular cases rarely have the level of knowledge or expertise that one finds in the securities sector, there are benefits to be derived in having regulators properly set and review these standards. This would ensure that the duties owed by various market participants to each other in the securities sector are set and controlled largely by securities experts.

The term fiduciary is derived from the Roman law, and means a person holding the character of a trustee, or a character analogous to that of a trustee. It has largely developed through Anglo-Canadian jurisprudence, and lacks the greater degree of tailoring that can be achieved by the direct regulation through statute. Given that certainty in commercial matters is critical to effective and efficient contractual relationships, markets and stakeholders can derive increased benefits from statues developed by experts who have a greater understanding of the nuances that exist in the business relationships in the securities sector.

Increased legal certainty achieved through standard setting by experts and stakeholders with a firm understanding of securities law and commercial needs is essential in gauging risk that factors so heavily in establishing contractual relationships. This is no easy task given that a single commercial relationship in the financial markets may involve the service provider in a number of different legal roles. For example, a dealer may be the client's trustee in respect of securities balances, and the client's agent in respect of the purchase, sale and settlement of a securities contract. Similarly a financial advisor is both the agent to the dealer and has an independent relationship with his client based on fairness, honesty and good faith. Clearly, not all the duties of a dealer or financial advisor are fiduciary duties, and fiduciary status does not affect all aspects of the commercial relationship, but only those relating to loyalty. Accordingly, the need to properly establish the 'duty of care' that will accommodate this reality is critical.

The permanent separation of beneficial and legal ownership that is inherent in interests in securities exposes the client to the possibility of bad faith or fraud by the intermediary that places the client's economic interests in securities at risk. The legal response has been to impose a duty of good faith on the intermediary who must then place the interest of the beneficial owner before his own interests. The essence of the fiduciary concept of good faith is faithfulness to duty, notwithstanding any conflict of interest. The fiduciary has an implied duty to place the client's interest above its own, and is subject to rules relating to no profit, no conflict, undivided loyalty, and confidentiality.[41]

A material distinction, with important consequences for financial advisors, is the absence of a link between the client's economic interests in securities and the role of the financial advisor in providing advice, and gathering and transferring personal information about the investor to the dealer. At no time does the financial advisor come between the property relationship that exists between the client and the dealer who is an intermediary of the client's property. This important distinction does not appear to be well understood, nor do rules created by SROs properly consider this important difference in developing or interpreting rules. From the financial

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[41] This general duty of undivided loyalty is capable of limited modification through contract in many circumstances to ensure commercially acceptable practices continue, however, the client's interests must remain foremost in the fiduciaries mind.

advisor's perspective, any unforeseen risk to the investor's personal property is limited to the activities of the dealer, third party trustee or a custodian. In failing to fully appreciate this distinction the SRO is creating regulation that more fittingly suits their members, and gives inadequate consideration to the impact on other stakeholders in the chain of the business relationship.

While the senior regulators have identified the material difference in the standard of duty owed by securities registrants to clients [42] the SROs have failed to appreciate the nuances that exist between the different stakeholders in the chain of distribution and focus to rigidly on the dealer and client relationship, and the fiduciary duty in equity that arises under trust law.[43] There are clearly elements in the client/financial advisor relationship that are independent of the advisor/dealer relationship and the client/dealer relationship.[44] There are also elements in the dealer/client relationship that do not require the higher duty of care at common law or equity.

Extending the requirements that exist under a trust to the general operation of reasonable business relationships is exceedingly limiting and harmful.[45] Of significant concern then is the regulatory creep that the concept of fiduciary obligation is experiencing through the interpretation of rules by the SROs. In focusing on the higher duty of care required under fiduciary obligations, the SROs are inappropriately focusing their considerable administrative authority on the activities and relationship between the financial advisor and the client when it is unwarranted. This is particularly troubling because as the SROs broaden their interpretation as to when a fiduciary standard exists, it results in increased compliance costs. It also leads to a very narrow view of how the distribution channel for securities is to be managed. If the actions of the SROs support the premise that they are inappropriately extending the concept of fiduciary duties beyond what is required to ensure consumer protection from unforeseen loss, and running counter the current established by the senior regulators, then one must question the ability of the SROs to work harmoniously with the senior regulator in achieving the desired regulatory outcome.

In brief, the over use of the strict fiduciary standard by the SROs erode the efforts by the senior regulator in striking the right balance between when securities registrants owe a duty of fairness, honesty and good faith, and when this is expanded to include acting solely in the client's best interest. A regulatory system operating from a PBR platform cannot succeed under these circumstances.

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[42] The *Alberta Securities Act*, and the DCSA provided by the Expert Panel both explicitly state that there is a high level of duty owed by the financial advisor to the client. Indeed, most registrants are expected to act fairly, honestly and in good faith, but this is short of the expectations one has of someone who is being held to a strict fiduciary obligation. The duty of care established for registrants through securities law in the DCSA are set out in section 53 which states, " (1) Subject to subsections (2) and (3), **a registrant shall deal fairly, honestly and in good faith with their clients**. *Duty of care — management of investment portfolios* (2) A registrant that manages the investment portfolio of a client through discretionary authority granted by the client shall act fairly, honestly and in good faith toward the client **and in the client's best interests**." This is consistent with the approach adopted by the Financial Services Authority (FDA) of the United Kingdom. The approach of the FSA is discussed in greater detail on page 17 of the Appendix.

[43] Please see my discussion on pages 17 and 18 regarding the use of PBR by the CSA and FSA to modify the equitable requirements of utmost good faith and best interests of the client, yet maintains a high level of consumer protection through requirements of fairness, reasonableness and management of conflicts.

[44] See the discussion on page 7, 8, and 12 *Role of the Independent Financial Advisor*.

[45] Please see footnote 28.

Advocis believes that the SROs are too focused on regulating to a fiduciary standard in situations where it is not necessary.[46] They fail to recognize the role of the financial advisor and the client as largely independent of the member's property relationship with the client. This approach to regulation is detrimental to financial advisors and contrary to the positive steps that have been taken by the senior regulators.[47]

A regulator that defines the market and its composition represents a very dangerous and limiting entity that will negatively impact the overall health of the market, and historically has proven damaging to consumers and the economy. We believe that the SROs are defining the market and its composition rather than working with all stakeholders to identify market failures and taking appropriate corrective action. We believe that financial advisors are inappropriately regulated by the SROs and that the SROs lack the expertise and objectivity to regulate financial advisors through their member firms.

In the Best Interest of the Distribution Channel for Securities

Most important to the long term interests of the distribution channel for securities, and investors, is a careful examination of the relationship between the client, financial advisor, and dealer. The actions of the financial advisor are exceedingly limited under the current regime and this has enormously negative consequences for the development of the distribution market in Canada. A reexamination of these relationships to properly identify unforeseen risks to ensure the proper regulatory response is implemented to address these risks will result in increased sectoral innovation. This in turn will benefit all stakeholders.

With the need for Canadians to be more reliant on their personal savings and investments, and less reliant on government programs, the time is now for a new regulator to examine the distribution channels for securities through the lens of the consumer's best and long term interests.

The proper regulation of the distribution channel of the securities sector requires an appreciation and understanding of the relationships and the risks that arise between: the client and financial advisor; financial advisor and dealer; client and dealer; and the role of intermediation in the handling of client assets.

The continued regulation of financial advisors by the SROs is resulting in the SROs defining the structure and composition of the securities distribution market in Canada rather than working with all stakeholders in identifying market failures, correcting them, and allowing the market to find the appropriate balance. In brief, the SROs as the proxy for the senior regulator are introducing moral hazard through removing competition within the distribution channel. Maintaining the status quo will likely lead to the ultimate removal of independent financial advisors from the marketplace. This would be very unfortunate for the market and investors as independent financial advisors represent an important entrepreneurial force in the distribution

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[46] Please see my discussion under, *PBR and Industry Guidance in Promoting the Increased Participation for Trade Associations and Professional Bodies*, where I discuss how principles in NI 31-103 appropriately regulate the concerns for consumer interests without applying a fiduciary standard. This is consistent with not only how the UK's FSA has dealt with this issue, but also how standard industry documentation (contract law) has preserved consumer protection from the unforeseen risk of loss. This approach provides both consumer protection and commercial certainty. Should the MFDA and IIROC continue on their current course, they will frustrate the positive steps made by the senior regulators.

[47] Ibid.

channel that, given the appropriate oversight, will act as a catalyst in moving the distribution channel forward to the benefit of Canadian investors.

2. PBR and Industry Guidance in Promoting the Increased Participation of Trade Associations and Professional Bodies

Recommendations:

- Implementing a PBR platform for all regulators in conjunction with the increased role for trade and professional associations will enhance the quality of regulation developed in the securities sector.
- The implementation of Industry Guidance will aid industry in structuring business practices to help achieve the regulatory outcome established by regulators. Further, Industry Guidance allows industry to be more proactive in providing solutions to identified market problems more quickly than regulators can.

Commentary:

The CSTO must develop the new securities act and common regulator based on principles.

- In looking at PBR more carefully one can isolate three key elements:
    - Broad-based standards in preference to detailed rules,
    - Outcomes-based regulation, and
    - Increasing responsibility for trade and professional associations, and senior management.[48]
    - The CSTO should closely examine the role of Industry Guidance by the FSA as the means to empower industry to bring rules and policies forward.

In a PBR environment the idea is for the regulated industry itself to design the detailed rules and procedures that will permit the standards set by the principles to be achieved. To help firms determine how best to meet the expectations under PBR, the FSA, for example, has turned to the regulated sector to provide sector specific guidance. It is expected that such guidance would come from industry associations, professional bodies or groups of firms.[49]

PBR places greater emphasis on individual accountability. The FSA in the UK has established eleven regulatory principles for business which include acting with skill, care, and due diligence. The focus is on regulatory outcomes and the individual participant will make their own decision, yet be accountable to the regulators and the public. Advocis' Code of Professional Conduct mirrors this approach through the establishment of broad principles regarding business conduct. The Code specifically addresses the best interest of the client, acting with integrity, competently, and, in accordance with the spirit and letter of the law. These general principles are supported by explanatory notes, and demonstrate the positive effect that PBR can have through allowing those who are regulated to help define the details. The onus in a principles-based environment is placed on the individual to determine the acceptable course of action.

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[48] J. Black, M. Hopper, and C. Bank, '*Making a success of principles-based regulation*', (2007) 3 *LFMR* 191.
[49] *FSA, Principles-based regulation, focusing on the outcomes that matter*, 2006.

The FSA, provides a good example of how PBR and the role of the regulated community regulating itself has moved regulators away from prescriptive rules making and allowed the same objectives to be achieved through principles.[50] Specifically, we have demonstrated how rules being developed and interpreted by the MFDA result in the application of a fiduciary standard on market participants. This is contrary to the stated position of the senior regulator, and the stated principles established by the MFDA itself.[51]

PBR Capture and Modify Fiduciary Obligations

The UK experience demonstrates that certain rules affecting fiduciaries are picked up in statutory regulations. The inspiration for the FSA's Principles for Business[52] relating to customers' interests,[53] conflicts of interest,[54] relationship of trust,[55] and client assets,[56] is equity. But the level of duty required by the FSA principles reflect, not the prima facie equitable requirement of utmost good faith and best interest of the client, but the more modest level of fiduciary duty typically achieved in the financial markets by the contractual modification of fiduciary duty. Firms must pay due regard to the interests of customers, and treat them fairly,[57] i.e. balance the interests of clients with their own, rather than always and loyally promote the clients' interests above their own. Conflicts of interest should be fairly managed,[58] rather than avoided all together. The emphasis on fairness[59] draws more on the language of consumer protection than on that of equity. The standard of reasonable care[60]is closer to the test of common law,[61]than that of equitable liability. Thus, equity has to some extent entered financial services regulation, but in a highly modified form.

Likewise the Canadian Securities Administrators (CSA) adopted a more principled approach in developing and implementing National Instrument 31-103 *Registration Requirements and Exemptions*. Part 13 of the Instrument, *Dealing with clients – individuals and firms*, has adopted an approach where fiduciary standard borne in equity are modified to reflect the commercial realities achieved under standard industry agreements and practice. For instance conflicts of interest[62]are dealt with through reasonableness and disclosure and not the strict equitable requirement of utmost good faith and best interest of the client. This approach is consistent with the proposed drafting of the duty of care contained in the DCSA provided by the Expert Panel, and the existing requirements under the Alberta Securities Act[63]. The focus is on dealing fairly, honestly and in good faith,[64]and the proper management of acceptable conflicts.

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[50] Please see my commentary under the heading, *PBR Capture and Modify Fiduciary Obligations* page 17.
[51] Please see footnote 27.
[52] <http:/www.fsahandbook.info/FSA/html/handbook/PRIN/2/1>.
[53] '6;Customers' interests. A firm must pay due regard to the interests of its customers and treat them fairly.'
[54] '8. Conflicts of interest. A firm must pay due regard to the interests of its customers and treat them fairly.'
[55] '9. customers: relationship of trust. A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
[56] '10, Clients' assets. A firm must arrange adequate protection for the clients' assets when it is responsible for them.'
[57] Principle 6.
[58] Principle 8.
[59] Principles 6 and 8.
[60] Principle 9.
[61] i.e. tortuous.
[62] Part 13, *Division* 2 *Conflicts of Interest* section 13.4 and 13.5, National Instrument 31-103.
[63] The standard is to deal fairly, honestly, and in good faith. Please see footnote 27.
[64] Draft Canadian Securities Act section 53.

The progress being realized at the level of the senior regulator is inconsequential if at the SRO level the interpretation given to rules is overly focused on the fiduciary obligations that arise in equity, and not the common law adaptation aimed at balancing commercial realities with consumer interest.

Increased Role of Trade Associations and Professional Bodies

The CSTO should examine and consider the effectiveness of Industry Guidance as a model that is be well suited to a Canadian securities market that operates from a PBR platform. Industry Guidance directly promotes the increased active management on the part of the regulated community in providing meaning to the general principles established by the regulator.

The effect of greater reliance on high level rules means that some in industry will want to know what guidance will be provided in aiding industry in fully understanding the principles. Guidance that comes from the regulator is generally more formal, and while not binding is given considerable weight by the courts. Accordingly, the FSA has looked to industry to provide guidance that will help the regulated community meet the regulatory outcomes established by the regulator.

In a PBR system the regulator acknowledges and embraces the idea that industry may wish to create it own guidance to assist firms and individuals that want more information on the regulators principles and high level rules. Guidance developed by industry makes use of the industry's expertise and results in a closer fit with commercial good practice. In turn, this should results in more effective and efficient regulation, and reduced compliance costs. It should also result in the efficient delivery of the regulatory benefit that the regulator is seeking to secure.

PBR envisions organizations such as trade associations and professional bodies playing a significant role in helping the industry develop suitable practices to meet their regulatory obligations.

Responsibility for the content of Industry Guidance lies with the provider. The regulator will only confirm Industry Guidance if they are content that it is consistent with their own rules, so that consumer protection will not fall below the standards they require and that it should deliver an improved regulatory outcome. Rules established by regulators should already aim to address an identified market failures and Industry Guidance should help to address the market failure.

In assessing whether to confirm Industry Guidance, the regulator will take into account the existence of the rule(s) the Industry Guidance supports and alternative options available to them including changing their own rules or not confirming guidance.

If industry takes action to address a market failure resulting in the regulator not needing to make rules, 'implicit recognition' could follow. By not making rules the regulator is acknowledging that the industry-based solution address the market failure and therefore firms that follow the industry-based solution should meet their regulatory obligations in that area. It would still be possible for the regulator to give more explicit recognition that a market failure has been addressed, by either issuing a confirmation or some other form of public statement.

Formalizing how Regulatory Confirmation is Granted

1. Requests for regulatory confirmation are examined on a case-by-case basis.

2. Those considering developing Industry Guidance for which regulatory confirmation is sought should inform the regulator at the earliest opportunity so they can plan efficient use of their resources and try to come to an agreed timetable.
3. There are three main stages to the process of granting regulatory confirmation: initial discussions; development by provider and regulatory review; and the regulators decision to grant the confirmation or not.
4. Those developing Industry Guidance can expect the regulator to get back to them and provide initial thoughts on whether the proposal can be considered for regulatory confirmation.
5. If the regulator is not inclined to grant regulatory confirmation, they will inform the developer and give clear reasons why. The process for agreeing to give regulatory confirmation will involve review and sign-off by several key areas within the regulator including policy experts, legal advisers and economists.

The regulator reserves the right to withdraw regulatory confirmation if they become aware that a piece of Industry Guidance is no longer appropriate. This would be where market developments or changes in regulations mean a firm would not be meeting the principles if it continued to follow a piece of confirmed Industry Guidance; or one of the regulator's parameters was no longer being met and this was seen as having a material adverse impact. The primary responsibility for ensuring Industry Guidance remains relevant, lies with the body/person that developed it.

The Legal Implication of Recognition of Industry Guidance

There are three conceptual ways that the FSA recognizes guidance, codes or standards developed by industry. The different forms of recognition have different legal effects. The three conceptual ways to recognize guidance are:

1. safe harbour,
2. sturdy breakwater, and
3. implicit recognition.

Safe harbour: has an effect on the regulator and potential third parties. The regulator would need to create rules to give Industry Guidance this effect and follow full statutory processes. As a result, this level of recognition would be more formal, and hence stronger, than a sturdy breakwater.

Sturdy breakwater: has an effect on the FSA but not on anyone else. It has the practical effect of preventing the regulator from taking action but does not affect the rights of third parties (including firms and consumers). For example, in order for the regulator to create a sturdy breakwater they need to take action of some sort (i.e. make a public statement) and therefore this form of recognition is explicit.

However, there are key differences between guidance generated by the regulator and Industry Guidance. Firstly, when giving formal guidance, the regulator is required to follow required processes, including consultation and analysis. Secondly, although guidance provided by a regulator does not bind the courts, in practice they are likely to give it significant weight.

Implicit recognition: has no legal effect on the regulator or anyone else. This deals with the case when the regulator has made no rules, guidance or other statement recognizing something.

The recognition is implicit in the FSA inaction, because the industry has found a solution to address a market failure, rather than in actions giving explicit recognition.[65]

3. Advisor Panel as a Statutory Requirement

Overview:

- It is widely recognized that consultation with a broad array of market participants will result in regulation reflective of the diverse needs of all stakeholders. This translates into improved, less intrusive, and less costly regulation that is more likely to achieve an appropriately identified market problem and have a higher degree of stakeholder buy-in. Consequently a higher degree of compliance can be expected. To this end, the Expert Panel has identified the need for an Investors Panel and Small Reporting Issuers Panel[66].

- Advocis strongly endorses a more focused and inclusive consultation process, and believes that a statutory requirement should be included in the proposed securities act that creates an Advisor Panel.

- Further, in structuring the common securities commission attention must be directed to whom is being appointment as a commissioner.

Recommendations:

- The statutory requirement for an Advisor Panel is necessary to ensure that all securities registrants and consumers are involved in the policy development process. It will also ensure the proper oversight of the new regulator.

[65] The discussion with respect to Industry Guidance is from the FSA.
[66] The DCSA, at s. 25 states, "(1) The Commission must establish and maintain an advisory panel to represent the interests of small reporting issuers and an advisory panel to represent the interests of investors. (2) Persons with knowledge of securities regulation, including issues relevant to small reporting issuers and investors, are to be appointed to the panel by the Commission. (3) Each panel is to be provide advise to the Commission with respect to both the existing and proposed regulatory policies and practices of the Commission. (4) The Commission shall take into account the representations made by the advisory panels. If the Commission disagrees with a view expressed, or a proposal made, in the representations, it must give the panel a statement in writing of its reasons for disagreeing. (5) Each advisory panel must provide the Minister with an annula report of its activities in the preceding fiscal year.

Commentary:

An Investor Panel only addresses part of the problem of developing a more rounded consultative process. The UK's *Financial Services and Markets Act 2000* (FSMA) requires the FSA to consult with both consumers and practitioners.[67] To bring meaning to this provision the FSMA stipulates that the FSA must establish both an independent Practitioner Panel[68] and a Consumers Panel.[69]

Advisory panels in the UK, and those proposed in the Draft Canadian Securities Act[70] play an important role in the development of policy. Although advisory in nature, the requirement for the regulator to respond in writing if they disagree with a proposal made by the panels ensures transparency and accountability on the part of the regulator. It also places a large degree of responsibility with the panel to ensure that any proposal they provide to the regulator is well reasoned and practical. Additionally, the requirement that each panel provide the Minister or FSA with an annual report will ensure that the advisory panels are operating efficiently, effectively, and will be held accountable for their participation in the development of policy in the financial markets.

Advocis fully endorses the Expert Panel recommendation that the new securities act include a requirement for panels. We urge the CSTO to recognize the inherent problem they will be creating in failing to provide an Advisor Panel, or at the very least a Small Business Panel. This serious flaw contained within the DCSA provided by the Expert Panel is best understood through a comparison with the experience of the FSA and the statutory requirement for panels under the FSMA.

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[67] *Financial Services and Market Act 2000*, s 8 states, "The Authority must make and maintain effective arrangements for consulting practitioners and consumers on the extent to which its general policies and practices are consistent with its general duties under section 2. Section 2 stipulates the general duties of the Authority.

[68] S. 9, The Practitioner Panel, (1) Arrangements under section 8 must include the establishment and maintenance of a panel of persons (to be known as "the Practitioner Panel") to represent the interests of practitioners. (2) The Authority must appoint one of the members of the Practitioners Panel to be its chairman. (3) The Treasury's approval is required for the appointment or dismissal of the chairman. (4) The Authority must have regard to any representations made to it by the Practitioner Panel. (5) The Authority must appoint to the Practitioner Panel such – (a) individuals who are authorized persons, (b) persons representing authorized persons, (c) persons representing recognized investment exchanges, and (d) persons representing recognized clearing houses, as it considers appropriate.

[69] S. 10, The Consumer Panel, (1) Arrangements under section 8 must include the establishment and maintenance of a panel of persons (to be known as "the Consumer Panel') to represent the interests of consumers. (2) The Authority must appoint one of the members of the Consumer Panel to be its chairman. (3) The Treasury's approval is required for the appointment or dismissal of the chairman. (4) The Authority must have regard to any representations made to it by the Consumer Panel. (5) The Authority must appoint to the Consumer Panel such consumers, or persons representing the interests of consumers, as it considers appropriate. (6) The Authority must secure that the membership of the Consumer Panel is such as to give a fair degree of representation to those who are using, or are or may be contemplating using, services otherwise than in connection with businesses carried on by then. (7) "Consumer" means persons, other than authorized persons – (a) who are consumers for the purposes of section 138; or (b) who, in relation to regulated activities carried on otherwise than by authorized persons, would be consumers for those purposes if the activities were carried on by authorised persons. Section 138 deals with rule making powers by "authorised persons" that will impact consumers. S. 138 (7)(a), (b), and (c) defines "consumer' for the purposes of rule making. The reference in s. 10 to s. 138 ensures that there is no ambiguity in the use and application of the term 'consumer' under the Corporate Governance section of the *Financial Services and Market Act 2000.*

[70] Prepared by the Expert Panel and provided to the CSTO for consideration.

The FSMA granted the FSA its powers and, as part of its accountability framework, the FSA was required to set up and maintain two statutory bodies – the Practitioner Panel and the Consumer Panel. These two bodies, in part, monitor the regulator's activities, ensuring that both buyers and sellers of financial products have a voice in the regulatory process. The experience of the FSA and the Practitioner Panel was that large issues and their concerns were mostly being addressed through this arrangement. Accordingly, in 1999 the FSA also set up the Smaller Business Practitioner Panel to represent the views and interests of smaller registrants and operate through the Practitioner Panel with its Chairman an ex officio member of the Practitioner Panel. This move on the part of the FSA was to address a weakness in the original drafting of the FSMA.

In the Canadian context, the CSTO has the opportunity to borrow from the best of the FSA experience and learn from their errors. A failure to include an Advisor Panel, or a the very least Small Business Panel, the composition of which would include advisors, will simply set the stage for problems shortly after the common regulator commences operation as a very vocal and important element of the Canadian capital markets will have been marginalized.

4. <u>Incorporation for Financial Advisors</u>

Provincial securities acts across Canada are drafted differently. This means that any stakeholder who operates in more than one jurisdiction must review the securities law in each jurisdiction to ensure they are operating within the law.

It is the difference in drafting between jurisdictions that contributes to the difficulties in resolving the long standing issue of advisor incorporation. Different drafting techniques mean that any legislative solution may require different steps in different jurisdictions.

Accordingly, the following analysis will work from the Draft Canadian Securities Act (DCSA)

The DCSA defines an 'adviser' as, "a person engaging in, or holding **himself** or **herself** out as engaging in, the business of advising others with respect to investing in, or buying or selling, securities or exchange contracts."[71] [emphasis added]

A 'person' is defined to mean, "an **individual**, company, partnership, unincorporated association, unincorporated syndicate, unincorporated organization, trust, trustee, executor, administrator or other legal representative."[72] [emphasis added]

An advisor in providing advice to clients with respect to the buying or selling of securities clearly fall within this definition of 'adviser' under the DCSA. Further there is not doubt that an 'adviser' can be a 'corporation'. However, one cannot conclude from the definitions that an 'individual' can be interpreted broadly enough to include a 'company'. Infact, the use of the pronouns 'himself' and 'herself', absent the term 'itself' in the definition, suggests that the use of the term 'individual' is not intended to include a 'corporation'.

The above reasoning becomes clearer when examined in relation to the registration requirements under securities law.

Section 52 of the DCSA sets out the requirements for registration. It states,

[71] Definitions section of the DCSA.
[72] Definitions section of the DCSA.

Requirement to be registered

52(1) Unless they are registered in accordance with Canadian securities law, a person shall not act as a dealer, and adviser or an investment fund manager.

*Requirement for **individuals** to be registered* [emphasis added]

(2) unless **he** or **she** is registered in accordance with Canadian Securities law, an **individual** shall not, directly or indirectly [emphasis added]
(a) deal in securities or exchange contracts on behalf of a person that is required to be registered under subsection(1);
(b) advise in securities or exchange contracts on behalf of a person that is required to be registered under subsection (1); or
(c) perform a prescribed function or duty for a person that is required to be registered under subsection (1).

The use of the terms '**he**', '**she**' and '**individual**' in the registration section supports our view that regulators would conclude that a 'corporation', not being an 'individuals', and being gender neutral, does not meet the requirements for registration and therefore cannot be 'in the business of advising'.

This concern is easily addressed and we would direct the CSTO to the *2004 British Columbia Securities Act*.[73]

The *2004 British Columbia Securities Act* defines an 'adviser' as, "a **person** engaging in, or holding **himself**, **herself**, or **itself** out as engaging in the business of
(a) managing an investment portfolio on behalf of another person, or
(b) advising another person in relation to investing in or trading in securities. [emphasis added]

The inclusion of the word 'itself' in the definition of 'Advisor' removes the ambiguity that exists in the DCSA.

The *2004 British Columbia Securities Act* defines 'person' to, "include[s] an **individual**, **corporation**, partnership, party, trust, fund, association and any other organization of persons, and the personal or other legal representative of any person to whom the context can apply." [emphasis added]

The BC definition of a 'person' addresses the concerns raised when words such as, 'individual', 'he', and 'she' are used through using the word 'itself' along with the words 'himself' and herself'. The definition of 'person' when used in the context of the *Registration requirements*, of the *2004 British Columbia Securities Act* clearly contemplates that a corporation can be a registrant.

Section 14 of the *2004 British Columbia Securities Act* states that,
"Unless registered, a **person** must not, [emphasis added]
(a) trade in securities, or
(b) act as an advisor.

[73] The *2004 British Columbia Securities Act* did receive third reading but was not proclaimed, as the BC government instructed the BCSC to focus their attention on passport rather than forge ahead with the new securities act that was drafted from a PBR platform.

The adoption of the British Columbia approach to the definitions of ‘adviser’, ‘person’, and ‘individual’, along with their approach to the registration requirements would provide the legislative changes needed for incorporation.

Registration Exemptions

Currently, those jurisdictions who have granted an exemption from the securities law registration requirements have set a number of conditions that would need to mirrored in an exemption order issued by the new common securities regulator, or be incorporated into the actual act.

The conditions are:

- A corporation of an individual registrant of a MFDA approved Mutual Fund Dealer or an IIROC approved Investment Dealer is exempt from the registration requirements of the Act, solely in connection with receiving an individual registrant’s commissions and fees from a registered dealer that is a member in good standing of an SRO, subject to the following terms and conditions:
    - The corporation must be incorporated under the laws of Canada or a province or territory of Canada and all of its directors, officers and shareholders are individual registrants affiliated with the same dealer;
    - Notwithstanding the first point, a family member of an individual registrant may be a director, officer or shareholder of the corporation. For the purposes of this paragraph, a family member includes a spouse, child, parent, grandparent, brother, sister, uncle, aunt, niece, or nephew of the individual registrant;
    - The corporation and dealer must have a written contract under which the dealer is liable for the acts or omissions of the corporation and the individual registrant who is a director, officer or shareholder of the corporation if these acts or omissions are related to or arise from the business of dealing or advising in securities;
    - Upon the request of staff of the regulator, the corporation will make any and all of its books and records available for inspection by staff of the regulator; and
    - Neither the corporation nor the dealer will engage in any practice with respect to the payment or receipt of commissions or fees, as the case may be, that is prohibited by, or otherwise inconsistent with, any rule, regulation, by-law, policy, notice, practice, procedure, bulletin or other regulatory instrument of the dealer’s SRO.[74]

The Significance of an Exemption Requirement from the Regulator

In order for a personal corporation structure to be viewed as a legitimate business, the personal corporation must actually be viewed as in the business of dealing in securities.

The proposition being put forward is that if the personal corporation is receiving commission from an individual registrant for trading securities, that personal corporation is trading in securities and must be registered.

[74] The jurisdictions that have provided exemptions from the requirement for the corporation to be a registrant are British Columbia, Manitoba, New Brunswick, and PEI. The conditions quoted are taken from Blanket Order # 33-504 PEI.

The existence of a registration exemption for personal corporations thus strengthens the argument that the personal corporation is in the business of dealing in securities, as the securities regulators are of the belief that to trade in securities the corporation must be a registrant. Therefore, exempting the corporation from the registration requirement is tacit acknowledgement that the corporation is in the business of trading in securities.