

IDA fails to get its analysis done

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Recent years have witnessed an extensive discussion on how to improve regulation to enhance market efficiencies and better safeguard investor interests, while reducing regulatory burdens and their accompanying costs. In our multi-jurisdictional securities regulatory system, this debate has focused on streamlining existing rules, removing duplicative rules and finding better rules to promote more efficient flows of capital across provincial borders. Canadian securities commissions, relying on mutual recognition for regulatory approval processes, have designed national policies and created a passport system to improve the existing regulatory regime.

Regulators have also generally accepted the concept of principles-based regulation. A principles-based approach has been adopted with particular success in the United Kingdom. It defines principles in core rules that guide business conduct. It builds incrementally on the rulebook by adding rules only where necessary to address an identifiable problem and only after a full cost-benefit analysis. It thus disciplines regulators to focus on outcomes -- key among them, treating investors fairly -- and it is cost-effective as it allows firms the flexibility to meet public interest objectives and avoid unintended consequences by organizing their operations efficiently.

The principles-based approach challenges regulators to determine overarching principles, find the right balance between principles and prescriptive rules, and exercise judgment in ensuring compliance. This differs from the traditional North American approach of adopting detailed rules that impose specific operational processes and then attempting to ensure compliance through a box-ticking exercise.

Whatever the approach, to avoid unnecessary regulatory burdens, regulators must identify a problem needing remedial action before adopting any rules and must ensure that the rules are targeted to the problem and are effective.

On January 30, the Investment Dealers Association Board of Directors approved the first phase of its client relationship model, the culmination of an almost 10-year effort to reform the regulatory framework governing advisor-client relations. Unfortunately, the IDA's proposed rules opt for the comfort of traditional practice. They mandate written disclosure to retail clients of the products and services offered by a firm, its relationship with the client, the process it follows to assess clients' investment objectives and risk tolerance, a description of the methodology it uses to determine suitability of investments, all costs the client may incur, information on the timing of trade

confirmations, account statements and performance information, a list of the documents to be provided to the client, and its procedures for handling client complaints. This mandated disclosure will require firms to publish a lengthy document that duplicates documentation already available from them and that will be costly to prepare and distribute.

On the basis of an analysis of the existing rulebook, the IDA identified a gap in the rulebook as the problem, and concluded that detailed mandated disclosure would be necessary to improve the client's understanding of the investment process. Intense competition in the wealth management business, however, suggests that firms already have every incentive to provide disclosure of the investment process demanded by their clients, particularly in modern retail markets which are characterized by sophisticated and complex structured products, unprecedented market volatility and clients searching for an optimal risk-return tradeoff.

It appears that the IDA did not preface its rule-making with an analysis of existing complaint data, a client survey, or other techniques to enable it to understand the importance of the regulatory gap to investors or to the advisor-client relationship. Its failure to carry out this analysis to help it define and address the regulatory problem results, in part, from its decision not to undertake a cost-benefit analysis to identify the benefits, if any, of its proposed rule to investors and to measure such benefits against anticipated compliance costs.

As the IDA recognized, a mandatory disclosure document can never be fully complete. The process for determining a client's investment objectives and risk tolerance is unique to each investor. Written documentation, wherever it originates, can only complement the discussions that occur between an advisor and client on the investment process and the rationale for specific investment recommendations. Advisors must deal honestly and fairly with their clients and are subject to know-your-client and suitability rules. Any satisfactory solution must rely on ongoing discussions between an advisor and his or her client. Indeed, it would simply be impractical to customize the mandatory disclosure document for every client. Accordingly, U.K. and U.S. regulators mandate that clients receive a document that contains similar information on the investment process, but does so only generically.

The Investment Industry Association of Canada recommends that the IDA require a concise standardized disclosure document that summarizes information on investment objectives, risk and suitability, and the firm's services, fees and processes,

and tells clients how to obtain more detailed material where they need further clarification. To further our common desire for fair treatment of investor-clients in an efficient and effective way, the IIAC has developed a model document of this nature and intends to submit it to the self-regulatory authorities and securities commissions for consideration.

The regulators must recognize that detailed prescriptive rules, whether related to disclosure or business process, often fail to provide a practical effective solution. This requires a more flexible approach that relies on core rules and principles of business conduct to ensure fair treatment of investors and cost-effective delivery of services by advisors.

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