SUBMISSION TO THE EXPERT PANEL ON SECURITIES REGULATION 10 JULY 2008

Does Canada Really Want Competitive Capital Markets? This would also mean, by implication, a Competitive Transparent Retail Financial Services Market Place?

Does Canada have the Culture and understanding of the problem, and a structure on which to build a principles' based regulatory system?

The following incorporates a background document passed to the expert panel prior to the TAMRIS Consultancy presentation to the expert panel on 18 June, and observations made during the ensuing question and answer session. This document focuses on a number of key themes

- The retail financial services market place cannot be ignored and is critical to the efficient allocation and management of economic and financial capital; failure to upgrade the regulation of standards in this market place will negatively impact savings, investment, consumption and production decisions for decades to come.

- The importance of including consumer interests in the regulatory decision making process as a prerequisite for developing and sustaining competitive capital markets.

- Canada needs to recognise the limitations and inefficiencies of a transaction based business and regulatory model, with limited accountability, which ignores the complexity of portfolio construction, planning and management (the fundamentals of suitability).

- Canada lacks a clear vision as to how the retail financial services' industry can best meet the needs for both suppliers of capital (consumers and savers) and users of capital (producers and investors). Its main focus appears to be enhancing returns to intermediation, which is besides the point.

The retail market: a critical component of the capital market

On reading the terms of reference and consultation paper for the Expert Panel on Securities Regulation (Creating an Advantage in Global Capital Markets), one cannot help but think that the main focus is on the potential returns from intermediation in global capital markets: that is, how best can Canada attract foreign capital to its markets, and how best can Canadian firms compete in global capital markets?

A focus on returns from intermediation is too narrow a focus if we are looking at the future of the Canadian economic and market paradigm, but, plausibly, wide enough if all we are doing is looking at protecting our financial institutions from competition and more efficient markets.

These (attracting foreign capital etc) are obviously key issues, but to ignore the importance of the efficient allocation of Canadian retail capital would result in a less than optimal market solution: capital markets represent the allocation of capital for saving and investment, consumption and production and this is capital held directly or indirectly by individuals. Corporations do not own capital, only governments (who act as fiduciaries in accordance with a democratic mandate) and individuals; to ignore the importance of the demand side in the allocation of capital would ignore vast tracts of accepted economic theory supporting the operational validity of competitive markets.

It is not clear from the terms of reference as to which components of the capital markets the panel is going to be addressing, and to what extent; it should be clear that an efficient, competitive, transparent retail financial services market place is critical to the allocation and management of capital; it should be more "productive"; it should require less capital to be allocated to intermediation; higher net returns (lower

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costs) should be earned by suppliers of capital, and issuers of capital should see lower costs of raising capital. Indeed, productivity growth is central to the efficient reallocation and accumulation of capital: an archaic, protected retail financial services industry is a barrier to such.

Just as higher government borrowing and expenditure crowds out private sector allocation of capital, so too does any market component that absorbs too much financial, intellectual and labour capital in its day to day operation.

Canada is a transaction based, clearly not efficient or competitive, market

It is clear that Canada has one of the highest cost retail financial services' market places in the world, and, in my opinion, one of the most restrictive in terms of competition, transparency and accountability. It is also predominantly a transaction led financial services industry: an operating structure which has higher labour intensity, is expensive for suppliers and issuers of capital and averse to process driven technological change.

A recent Tufano, Khorana and Servaes research document into mutual fund fees around the world stated that Canada had the world's second highest mutual fund fees, and the highest equity mutual fund fees in the world with total annual service costs averaging 3% per annum. Other research (note John Bogle of Vanguard) states that average transaction costs (not included in total service costs) for active mutual funds are some 1% per annum.

If we look at say 11% annual average compound total return on equities over a 50 year period, a 3% total annual service cost would reduce the return to the average mutual fund investor to 25% of the total market return. If we add annual transaction costs of 1%, the average annual return would fall to 16% of the total market return. It should be clear that this does not provide for an efficient allocation of capital; on the contrary it may well provide an inequitable and inefficient reallocation of private investor capital.

An efficient market place would reduce costs through competition, innovation and the productivity growth that springs from competition. To understand the impact of costs on the efficient allocation of capital you need to drill down to the fundamental economic structural relationships: these are the relationships that govern the savings, investment, consumption and production decisions within the economy. A high cost financial services industry reallocates a significant component of the return on capital away from this iterative decision framework, impacting the efficient long term allocation and management of economic and financial capital.

We must not underestimate the importance of productivity growth to our economy or the impact on growth of the capital that productivity growth releases: it can have a powerful compound impact on long term economic growth.

Changes to the regulatory structure to increase the efficiency of the economic/market relationship, like the visible impact of charges on investment returns, will take time: it may take five to ten years for the retail financial services market place to adjust to a new regime, and up to 20 years to appreciate the compounding of marginal capital released by a more competitive retail financial services industry.

Uncompetitive regulatory structure

It would appear that regulatory structures have served to protect the interests of the status quo, and have helped to subvert the interests of competitive, efficient retail financial capital markets. To address Canadian capital markets without dealing with the retail financial services market place would be an oversight of consequence. Indeed, one of the prerequisites of competition is the existence of two parties with access to the necessary information needed to bring equilibrium to quality, quantity and price; to exclude a party from the regulatory and economic rule setting process is to lose the balance needed to efficiently set prices, quantities and quality in the market place.

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As such, the regulatory process should mirror the imperatives and relationships of the market and economic relationship: without such, neither a rule nor a principles' based system has the necessary credibility to foster consumer protection and confidence in capital markets.

The importance of the retail financial market place to the integrity, efficiency and competition of the capital markets should be clear, yet consumers have no voice in the process, and attempts that have heretofore been made to improve the market place in their favour have, to all intents and purposes, been overridden by industry interests: the Fair Dealing Model and its clear understanding of many of the problems is a prime example, as is the lamentably vague complaints' process that is only now being considered for an upgrade to standards well below other country best practises; even the narrowly focussed financial services industry ombudsman is effectively beholden[1] to the industry and its standards.

As noted above with respect to the impact of costs, Canada does not have an efficient and competitive retail financial services market in the context of efficient allocation and management of economic and financial capital.

There are many other issues that reflect the state of regulation in Canadian retail financial services market place and that can only reflect negatively on confidence in the market place per se: note the time it has taken for the joint forum of regulators to produce a draft point of sale document[2], yet another area in which Canada does not match up to international best practises.

A transparent competitive perspective

The reasons why the Canadian retail financial market place is inefficient and uncompetitive are many and complex. One way of looking at it is to imagine a situation where the average Canadian investor was imbued with the information that they would need to set price, quantity and quality and hence to create an efficient competitive market solution.

Indeed, the existence of an independent consumer panel with a mandate to create accountability and transparency in the financial services industry, with statutory based input to the regulatory decision making process, would go some way towards such.

Imagine the change in the competitive landscape of the Canadian retail financial services industry if the average Canadian investor became aware of the following;

a) the impact of costs on risk, return, performance, and ultimately long term financial security,

b) that, in the current regulatory environment, it was they and not their advisors (advisory based relationships), who were responsible for their investment decision, that

c) the industry was not (technically) deemed to be a provider of advice *(even though it portrayed itself as such)*, but a purveyor of the transaction, and was not apparently responsible or accountable for the deliberations (*the structure, process and intent driven by the advisor and industry*) that led to the decision by the investor to accept the advice (transaction),

d) that the complaint process, if they were ever to have need of it, was adversarial, inefficient *(unstructured)*, ineffective, loosely regulated, opaque and weighted in favour of the firm and the industry and that

e) necessary transparency over remuneration and costs, responsibility for investment decisions, the nature of services offered, the risk and return profiles of and rationale for investments recommended was limited, obscure, and that the regulators have allowed such to continue while

[1] See TAMRIS Consultancy document IDA Complaints Process and OBSI Terms of Reference
[2] TAMRIS Consultancy July 2007 – Commentary: Joint Forum of Regulators Point of Sale Document

aware of the limitations and risk of the consequences (*note the Fair Dealing Model, Glorianne Stromberg and others*),

f) that Canada's transaction and services costs were well above the global average and that standards governing (d)and (e) were below global best practises,

g) that constructing a portfolio of investments to meet financial needs while managing risk and return in a manner that reflects their risk and performance preferences is complex and above the ability of a transaction led industry to deliver. While they may be able to understand the generics of risk and the benefits provided by a structured, disciplined, personalised approach to managing their needs, and are able to accept the consequences of such, they do not possess the expertise or resources to do this themselves or to accept responsibility for the integrity of the processes required to deliver such. In this context they are relying on the organisation to have the processes and structures in place to deliver the promised services: the financial services industry has a fiduciary responsibility to ensure that the processes, disciplines, structures and expertise needed to deliver wealth management advice and recommendations are appropriate for the service contracted.

If Canadian investors had the information that they would have in a truly efficient market place, the financial services industry as it is now could not exist; while a transaction based component would still exist, this component would be unrecognisable from its current guise. We have the technology and the investment expertise to deliver much more efficient wealth management solutions to the retail market place, yet we are nowhere near an efficient and competitive market for retail financial services: this must surely be an objective of any regulatory reform.

Unfortunately, the average investor is largely ignorant of the physics and realities of investment, and the conflicts of interest within the investment industry and regulatory structure. Consumers need an independent body (who would possess this knowledge) to represent their interests in the determination of competitive standards and regulation for the retail financial services industry.

The registration reform project's assessment of the Fair Dealing Model, which, to my mind was largely influenced by the retail industry's view of what was and what was not practical, suggested that the costs of transparency, communication and education were too great, and the benefits (*to whom?*) too small, to justify change. A move to a more efficient industry would require a change of business model and initial capital investment in new processes, systems, and human capital skills would need to be upgraded.

A more efficient industry would employ less people and would have lower margins; it would also utilise less capital; it would leave more capital in the hands of consumers to better make their own saving and consumption decisions and issuers to make their own production and investment decisions. It should be no surprise that the status quo would like to pre-empt such an outcome, but they are intermediaries and the needs of efficient allocation of capital should be paramount.

Canada needs a vision of the future of its wealth management industry and a regulatory structure to allow this vision to flourish.

Consumer responsibility

There was a feeling based on feedback from the panel that it was the responsibility of the consumer to educate themselves and to make their own choices, given the range of options and information available to them. This presumes that the information currently available to investors (to enable education and investment decisions) is uniformly credible and objective, that the choice of service, product options and costs is relevant, effective, appropriate and accessible, and that the retail industry is accountable for their actions and their communications; much information provided to investors is far from credible and at times self serving and misleading; the choice of options delivered to the retail market is not always appropriate,

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effective or accessible, and accountability for the presentation of service and product outcomes seemingly non existent.

One of the reasons for this state of affairs is that the Canadian Financial Services' industry is stuck in transaction mode, a mode that is not geared towards delivering the cost effective, integrated, accountable, process driven wealth management service solutions that would mark an efficient, competitive industry and that many consumers of financial services think they are already getting. The choice, quite frankly, does not presently exist, likewise the information required to enlighten investors over the reality of choice. I have seen numerous instances of incorrect and misleading statements and calculations of risks and benefits that have passed regulatory muster.

The panel needs to assess its views with respect to how it intends to create a "balance of information/power" in the retail financial services market place to foster the development of an efficient and competitive market place. If it expects the individual consumer on its own to shape the market within the current regulatory and competitive framework, then the retail financial services market place will be a significant impediment to Canadian economic prosperity. Likewise, if the panel believes that a narrowly focussed transaction driven industry is the way forward for the Canadian retail financial services' market place, then it must also consign itself to operating at standards well below those currently in place in other countries at a time when it is conceivable that international standards and best practises will continue to evolve.

Principles versus rules based

The terms of reference and consultation document also addressed the issue of principles' based regulation. A principle is a fundamental rule that can be discerned from observing the physical relationships comprising structure and process. As such, a principles based system cannot exist without a detailed understanding of the components of structure, the relationships and exigencies of structure, and the objectives and structure of process (outcomes): a principle should offer a clear enunciation of a preferred outcome.

I do not believe that there is sufficient enunciation of the preferred structure and understanding of the problems and relationships comprising the retail financial services market place to be able to move to a principles' based system.

In order to have a principles' based system, regulators, stakeholders and government need a vision governing the direction of the development of the industry. To date there has, in my opinion, been little or no regulation of the retail financial services market place (*such a market place extends far beyond the limited realm of the transaction at the point of the transaction*) and little or no culture of addressing the problem; what little regulation there is has been focussed on the narrowly defined context of the transaction at the point of transaction; this is no basis for the future regulation of the industry.

Systematic issues/risks

A system is both a structure and a process; a systematic risk is anything which risks the integrity of that structure and process or the integrity of a relationship which depends on that structure and process. A flawed system is a systematic risk in itself.

A financial services market place that only focuses on the transaction, a regulatory system that lacks symmetry (note that the necessary symmetrical relationship with the market and the regulation of the market is impaired given the absence of consumer interests in the regulatory process), that believes that responsibility and accountability is limited to the confines of the transaction, that misunderstands the suitability process, is flawed and poses a **systematic risk** to investors and the efficient allocation of capital.

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Financial literacy

I agree with efforts to enhance financial literacy: I believe that investors need education to be able to select the wealth management solution best suited to their financial needs, risk and performance preferences and to allow them to accept responsibility for the generics of the decision; but not the processes that underpin the solution if these are impaired.

However, the processes, systems and expertise needed to deliver a suitable wealth management solution currently lie outside those used by the industry at large. Education would allow investors to force change in the market place, but this of course depends on the integrity and objectivity of the education itself. Look at any standard leveraged investment marketing brochure and you will come up with the conclusion that only an idiot would not leverage; most so called financial services education material is designed to sell. Even the OSC's "checkbeforeyouinvest" website provides documents that are, in my opinion, less than balanced in their objectivity.

The panel therefore also needs to be able to address the objectives of education, but before it can do this it needs to know the limitations and responsibilities assumed by education for a given retail financial services' industry operating objective: in a transaction based system where suitability is deemed to be limited to the transaction and not the whole, then education is focussed on making sure the investor understands a) the type of transaction he or she is looking for, b) the transaction the salesperson thinks meets the client's requirements and c) the risks, costs and benefits of the transaction recommended. As stated, this operating structure is not optimal, efficient or competitive in terms of being able to efficiently allocated and manage financial and economic capital.

Summary & Recommendations

My concern is that the current review of the regulatory system may not have the time to fully understand the problems in the retail financial services' market place, and that the interests of the investor and consumer may not be properly represented in the process. Such lack of representation will also impact the ability to properly assess the performance, analysis and recommendations of the panel itself. As discussed, a market place depends on both buyers and sellers interacting for its efficiency; the decision making process in the regulatory framework should reflect this and should be symmetrical with the market place itself.

Canadian retail financial services needs higher levels of transparency regarding costs, risks, the nature of services being provided and the responsibilities to be undertaken jointly by investors and financial intermediaries to better set quality, quantity and prices in the market place; the ability to sell asset backed commercial paper, income trusts, principal protected notes, leveraged investments, segregated funds and variable annuities, and high cost mutual funds (amongst others) would all have been impaired by higher levels of transparency.

Exposing the industry to higher performance criteria can only improve its efficiency and its ability to compete: as it is, foreign institutions may have the technological lead and superior processes to operate in Canadian markets if they were allowed to compete fully in this market.

Canada needs to accept that the retail financial services industry is not limited to the transaction at the point of sale, but extends to the overall suitability of an investment: an investment's suitability is determined by its relationship with all an investor's assets, by its relationship with the size and timing of all an individual's financial needs (income and capital liabilities) and by its relationship with the client's risk and performance preferences.

Suitability therefore requires processes and systems (of little use in a transaction based system) that can integrate all these factors within the wealth management solution; the decision rules, structure and processes governing the delivery of these solutions are the responsibility of the financial services' industry and not the investor. All (most) investors can do, is make a decision about the generics of risk

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and return, not the structure, the process, discipline and methodology underpinning those solutions; these are the responsibility of the institutions and this is a fiduciary responsibility even though the responsibility for accepting the generics of the decision are the client's.

In the end, the market place (the market portfolio of cash, bonds, equities and other assets) should reflect the saving, consumption, investment and production decisions of the economy; a system which impairs consumers ability to save, to manage the risks of saving and consuming capital is a risk to the economy; a system which reallocates too much capital within the financial intermediation industry, and hence misallocates capital needed in production and investment, that is also averse to pressures to increase productivity, is a risk to the economy.

We need to think beyond the demands and interests of the financial services' industry to the needs of the economy and the balance of saving, investment, consumption and production, in order to represent the interests of the key players; the consumers/savers of capital and producers/investors of capital. Take care of this and the capital markets will take care of themselves.

Focusing only on the returns to intermediation and the attraction of foreign capital[3] to the domestic market ignores important structural economic relationships likely to have a significant impact on long term economic growth and prosperity. We also live in interesting times: financial services' companies, the world over, are in the process of writing down capital after an irreverent period of financial excess. The current environment is therefore one in which capital values and the returns on capital are falling, with significant risks to consumer expenditure which has grown increasingly reliant on asset values. In this environment it makes sense to focus on increasing returns on capital through lowering costs and increasing the productivity of the financial services industry. To do this the forces of competition need to be better represented in the regulatory process as a first step.

This document could have focussed on a host of other important issues relating to low standards in the operation and regulation of the Canadian retail financial services' industry. Instead, it chose to focus on key structural issues that should transcend opinion and self interest. Nevertheless, I am in broad agreement with a large number of issues raised by investor advocates, and believe that many of the industry's practises - though they do not transgress the few regulations that exist – could in another regulatory environment be effortlessly classified as financial abuse. This is of relevance if we are to codify regulation into a principles based structure.

The expert panel needs to be able to define the principles on which the retail financial services' market place is to operate; these principles will need to be backed up by the detail needed to define its structural and operational integrity. Does Canada really want an efficient, competitive retail financial services' market place? We will know whether this is the case at the end of the current review, but I believe that we are at a turning point: Canada expects.

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The TAMRIS Consultancy

TAMRIS is a "Total Asset Management Research" consultancy dedicated towards improving the structure and quality of asset management within the financial services industry. It operates as an independent medium between the consumers of financial services and the providers of financial services.

[3] Given that domestic money supply at a point in time is fixed, foreign capital does not actually enter a domestic market: all that happens is that ownership of a domestic asset is transferred overseas leaving the same money supply chasing fewer assets; if there is a capital shortage in the economy this releases monetary demand/capital for other domestic production opportunities. However, it would also make sense to look to increasing productivity in Canadian industry, which, would also release monetary demand/capital whilst retaining domestic ownership.