9 August 2004

Mr. John Stevenson, Secretary
Ontario Securities Commission
20 Queen Street West
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Toronto, ON M5H 3S8
Submitted by email to: jstevenson@osc.gov.on.ca

Dear Mr. Stevenson:

I appreciate the opportunity to submit comments on the Fair Dealing Model of the Ontario Securities Commission.

My overall impression is that the Fair Dealing Model makes a positive contribution to promoting fairness in business dealings in the investment industry--especially in its focus on relationships and in its more nuanced consideration of 'transparency'. The broadening of this concept allows consideration to be given to how decisions are made and how information is provided to the client in support of these decisions.

As an academic (in philosophy), I appreciate the systematic approach taken by the Fair Dealing Model in the way it determines the fairness of business conduct. A potential difficulty addressed by the model is that fairness is a higher order value or formal quality of judgments and conduct, rather than a measurable quantity or fact. In my view, the FDM takes the right approach in considering fairness relative to more concrete aspects of the relationships in question, such as responsibility for decisions, degree of reliance on the part of the client, transparency of communications, and conflict management. These fundamental elements (the core principles of the model) function as co-factors, which allow fairness (and correlatively unfairness) to be determined in an objective manner.

The Request for Comment notice indicates that the present concept paper, containing business conduct standards, is the first component of the Fair Dealing Model. My understanding is that these standards are designed to regulate relationships between clients and representatives relative to considerations of fairness--and, therefore, relative to the factors mentioned above. If these factors are impaired in a certain relationship, for example, if there was unmanaged conflict of interest, as well as lack of transparency in communications, then fair dealing would be questionable in that relationship.

The primary focus of the concept paper is the client/ representative relationship at the investment level. Nevertheless, certain additional services are also provided by firms. In the case of a dispute arising at the investment level, a new relationship is formed--between the client and the firm's Compliance Officer. In some instances, where a client cannot accept the decision of the Compliance Officer, there is a further internal review by the firm's Ombudsman.

My comments on the Fair Dealing Model will consist of an analysis, within the framework of the model itself, of the client/representative relationship that occurs in the context of internal account reviews. In the event of a dispute between a client and his or her investment adviser, the firm's Compliance Department conducts a review to determine whether there has been wrong doing with regard to the adviser's handling of the client's accounts. The main consideration in my present analysis is whether the client/representative relationship in this context is objectively impaired relative to the factors that constitute fair dealing.

While this kind of relationship also falls within the scope of a model designed to regulate the business conduct of financial service providers, the Fair Dealing Model does not address relationships at this level in the current paper. Consideration of this relationship from a regulatory standpoint would seem especially important if the following factors were found to be present: a high degree of reliance on the part of the client, perhaps even at the fiduciary level, together with conflict of interest and lack of transparency in communications. These factors, however, need to be considered in the context of the relationship in question.

The Fair Dealing Model presents a spectrum of relationships at the investment level--from Self-Managed to Managed-For-You, with increasing degrees of reliance on the part of the client together with increasingly stringent requirements with regard to conflict management. Whereas the client is free to choose the type of relationship at the investment level, this choice does not exist in a review of the client's accounts. Where in the above range should the client/representative relationship be situated in this case?

There is reason to believe that it should be classified along the same lines as the third kind of relationship at the investment level. The judgments that determine the outcome of the review are the sole responsibility of the firm's representative. The representative makes the decision and determines the outcome for the client. In view of this, I believe it would be correct to describe this relationship as 'Decided-For-You', equivalent to the Managed-For-You relationship at the investment level. This view is supported by a legal opinion I received on one occasion that the client/Compliance Officer relationship is fiduciary in nature.

At the same time, there would appear to be conflict of interest in this relationship (at least potentially) in that a representative of the firm is investigating the conduct of another representative of the firm and there are financial incentives associated with the outcome of the investigation.

The concept paper notes that reliance and duty in the Managed-For-You relationship are at a fiduciary level and states that this relationship "tolerates virtually no conflicts" (36) and that "no conflicts are permitted without the client's informed consent" (35). It seems problematic, therefore, that in the relationship that occurs in an internal account review, there is both a high degree of reliance by the client on the representative and potential conflict of interest. Evidently there is also lack of transparency in communications as I will discuss below.

One of the major goals of the Fair Dealing Model is to provide standards of business conduct that address conflicts of interest between clients and financial service providers. On p. 35 of the concept paper there is reference to "incentives," which may benefit the representative or the firm and may conflict with the interests of the client. The most obvious incentive at the investment level is profit. Obviously, in the context of an internal review of the client's accounts, the profit motive would operate in a different way than at the investment level. It would not be a question here of compensation driving behaviour, but of behaviour being driven by an interest in avoiding compensation, i.e. to the client.

The locus where interest would operate in this case is not investment advice, but the judgments made about the handling of the client's accounts. In the context of an internal review, the need to compensate the client would arise from a determination that there was evidence of wrong doing with regard to the professional services of the client's investment adviser. Conflict of interest arises in the event that such evidence is found, since there is also a financial incentive to reach a "no evidence of wrong doing" judgment.

In the Fair Dealing Model, the word "bias" is used to refer to "recommendations that are driven by compensation" (36). In the present context, bias would occur in judgments driven by aninterest in avoiding compensation, i.e. to the client. Of course, if there is no evidence of wrong doing, then a judgment that reports this will not be biased. But, where bias exists, whether it is a matter of biased advice or biased judgments, the result is a self-serving outcome motivated by profit, which harms the interests of the client. Within the framework of the current model, such dealings are determined as being objectively unfair.

Another consideration is that although conflict of interest is present, at least potentially, in an internal review, the process is represented to the client as an 'objective and impartial investigation'--as though conflict of interest either is not present or is fully managed by the firm. The word 'independent' is also used, although clearly such independence is relative as long as the review is being conducted by a representative of the firm. Considered more generally, the firm is making judgments about its own dealings under conditions where there is a financial incentive to act in its own interests. Two considerations arise from this.

Representing the account review as an 'independent, objective, and impartial investigation' inevitably positions the client in a manner that is in the interests of the firm. If the client believes that the outcome has been reached through this kind of process, then the client will be more inclined to feel that the matter has been settled and will be less likely to question the decision in further reviews, e.g. by the regulator. Nevertheless, the client is not in a position to verify that the process is objective and impartial and so really this is just a claim.

Another consideration is that the construal of the process as independent, objective, and impartial, masks the conflict of interest that is potentially present in this relationship from the client. In view of this, the use of these terms could give the client a sense of assurance about the fairness of the process, which may be unwarranted.

Observing that the client remains free to accept or reject the outcome of the review process does not address the problematic aspects of this relationship. Why should the client believe that the outcome of an objective and impartial investigation is unreliable? It may be that a "no evidence of wrong doing" (hence no compensation) judgment is not to the client's liking. The question is whether clients should have reservations about relying on these judgments. Last fall, in the context of an article in the press on complaint procedures at investment firms, a lawyer made reference to the fact that firms know that many clients give up after receiving a letter from the Compliance Department denying any wrong doing. But, just giving up is not deciding properly. One concern is that it may not be possible for clients to make proper decisions about accepting or rejecting outcomes in the context of this relationship owing to a lack of transparency in the way judgments are communicated.

The concept paper states that "All dealings with retail investors should be transparent" (28). 'Transparent' and 'opaque' are metaphors with multiple applications. In the FDM, one meaning of 'transparent' refers to the provision of information relevant to making decisions about investments. It seems clear from the model that the investor's decision in the Advisory relationship is based on quite a lot of information, at least ideally, and that one purpose of the new regulations is to ensure this is provided. Moreover, conflict of interest relating to compensation is managed by disclosure requirements.

In the context of an internal account review, the only decision made by the client is whether or not to accept the outcome. The relationship with a representative at this level differs significantly from the Advisory relationship. In the latter, the investor makes the decision--in reliance on information provided by the adviser. In the Managed-For-You relationship, investment decisions are made for the investor by the adviser. Similarly, in an account review, the outcome is decided for the client by the representative. The client does not participate in making this decision, which is the sole responsibility of the representative. In the Advisory relationship, the reliance is partial, but in an account review relationship, evidently there is complete reliance on the judgment of the representative with regard to the substance of the decision. This is analogous to the reliance of the client on the adviser in the Managed-For-You relationship at the investment level.

There are disclosure requirements to manage conflict of interest at the investment level, and strict requirements in the Managed-For-You relationship. It does not appear, however, that there is any obligation or requirement on the part of the representative in an account review to disclose to the client any aspect of the decision-making process that could lead to self-serving outcomes. Obviously, if the representative was going to judge matters in a way that favoured the interests of the firm or the adviser at the expense of the client, then it would be self-defeating to disclose this to the client.

The following analysis will consider the judgments made in the context of internal account reviews according to the wider scope of the meaning of 'transparency' in the Fair Dealing Model (pp. 31-2). Specifically, it will consider how judgments are communicated to the client (their form) rather than what the judgments are about (their content).

With respect to content, the judgments are about various aspects of the handling of the client's accounts by the investment adviser relative to the concerns raised by the client.

With regard to form, there are two considerations: the specific kind of judgments made in a Compliance Department review and the nature of reasoned judgments more generally (according to the general form, 'It is reasonable to believe that X, given A,B,C.').

I have had experience with three reviews of my accounts conducted by a large firm. In the context of the initial Compliance process, I requested a definition of 'compliance', noting that this was a relational term that implies 'being in accordance with.' The Compliance Officer responded:

"Our process is to review a client's concerns to ensure of compliance in accordance with both the firm's standards and those established by the Regulators, i.e. the Investment Dealers Association."

The kind of judgment involved here occurs in several areas. For example, there are compliance officers in health care who oversee the compliance of hospitals with standards pertaining to medical treatment and patient care. The following is a simple example of a compliance-type judgment in the context of the food services industry.

I recently came across a Notice of Impending Termination that had been left on the subway by a Pizza Pizza employee. The document states that on a certain day, the employee "was found eating food while on the production line of Waveside Pizza Pizza." It notes further that the conduct in question is "a food service health and safety violation" and also that it is contrary to "Park Policy and Procedure" and moreover that "it is considered theft." The document also states that in the context of the employee's training program, he would have been informed that "this behaviour is unacceptable."

This is a straightforward, objective determination of wrong doing in which there is consideration of the employee's conduct in relation to the applicable standards and regulations.

In the letters I have received at the conclusion of each review, the overall decision is formulated in terms of 'evidence of wrong doing.' On the basis of the above definition, evidence of wrong doing will consist of evidence of non-compliance relative to the applicable criteria: regulatory, institutional, and professional standards.

In a review of the client's accounts, the role of the firm's Compliance Officer (or Ombudsman if there is a further process) is to make such judgments in an objective and impartial manner, uninfluenced by the incentive to reach an outcome that serves the interests of the firm, i.e. avoiding compensation to the client.

The main focus with regard to transparency in this context would be how the conclusions of the representative are communicated to the client. Judging by the letters I have received, as well as information from other sources, it appears that written judgments are communicated in a manner that is highly opaque. The very general "comments" in these letters do not in any way resemble compliance-type judgments as defined and illustrated above. There is little or no reference to supporting data and documents nor is there any analysis in terms of applicable standards and regulations. Overall, there is no attempt to present decisions in relation to the compliance-type judgments that supposedly were made in reaching them. Considered more generally, the opinions regarding the various matters are not presented as reasoned judgments or the grounds are inadequate. I was informed by an IDA complaints officer that this kind of response, containing highly general, unsupported opinions, is typical of Compliance Department letters.

Under the circumstances, the client has no way of verifying the soundness of the conclusions nor the fairness of the outcome. This problem may be illustrated as follows. If person A communicates to person B the judgment "2+3=7" then B will have been provided with the means of verifying the sum and will be able to recognize that it is wrong. But, if A merely says "I have added two numbers and the sum is 7," then the wrongness of the sum will be undetectable. In this case, the result is communicated in a manner that is highly opaque relative to the way it has been reached. In fact, this is not disclosed at all. Based on this analysis, it is clear that communicating a decision in an account review, without disclosing how the decision was made, has the potential to mask bias and unfair outcomes from the client.

The specific meaning of transparency in this context would be 'disclosure of the grounds of judgment,' i.e. the provision of reasons, data, analysis, and reference to applicable criteria in support of judgments, ideally in a compliance-type form.

In a situation where a person was receiving a medical opinion, the transparency requirement could be less stringent because there is no incentive for a doctor to report one outcome to a patient rather than another. As the Fair Dealing Model recognizes, however, transparency issues are a consideration where advice (or in this case judgments) are subject to the influence of financial incentives.

The kind of deficiency noted above does not concern what is communicated (content), but how it is communicated (form). It therefore may be referred to as a 'formal deficiency'. The judgments in question appear to be formally inadequate not only relative to compliance-type judgments properly speaking, but also in relation to reasoned judgments more generally. With respect to the latter, there has been reference in the press

recently to other occurrences of the same deficiency in a judicial context (in the article, "Back up your verdicts, judges warned in ruling," Toronto Star, May 29, 2004, A27).

The article reports that in several recent cases, lower court decisions have been overturned "because of serious deficiencies in a trial judge's ruling." It is not a question here of a discovery of new facts or evidence (which would pertain to the content of the decision). Rather, the finding is that the decisions in question were inadequately explained and hence deficient in their reasoning. The evidence in this case is the transcript of the decision.

On the basis of the written responses I have received, as well as the above information from the IDA, it appears that the judgments communicated in the context of internal account reviews have a similar formal deficiency. Reasons or grounds for opinions either are not provided or they are insufficient to allow the client to verify the soundness of the judgments and the fairness of the overall outcome.

This problem is especially acute where the Compliance Officer (or Ombudsman) does not address certain concerns or questions at all in the written response. In one of my discussions with an IDA complaints officer, I was informed that in this case the client has to take their complaint to an external agency, such as the regulator, who can access the client's file--in order to find out how a question about their accounts has been addressed by the firm's Compliance Officer. In this case, the client's question has been "addressed" in a purely internal process in which the judgment about the issue has not been disclosed to the client at all.

Lack of transparency in the way judgments are communicated makes it necessary for the client to depend on the representative in accepting decisions. This is analogous to accepting a view about a matter on the basis of 'expert opinion'. In this case, one does not hold the view on the basis of one's own reasoning or because one has verified the reasoning of another. Rather, one accepts the opinion on the basis of reliance on the authority and expertise of the other person. It seems that such acceptance would be problematic in a relationship where there was no provision to manage conflict of interest.

The danger of harm in this context is analogous to the danger of harm in a judicial setting where improperly reasoned judgments can mask the miscarriage of justice. In overturning a recent trial decision (as reported in the above article), Justice John Laskin questioned the reliability of conclusions where supporting reasons were inadequate. It seems clear from the mathematical example, above, that in such cases the conclusion could be right--or, it could be wrong. But, if the conclusion is wrong, this will not be apparent because its wrongness will be concealed by the fact that it has not been explained. This is clearly illustrated by the example, "I have added two numbers and the sum is 7." The reasoning is not provided and so the conclusion is unreliable. As Plato would say, the opinion is not 'tied down' with the reason why (logos) and hence is unstable (it could be right or wrong).

If inadequately reasoned trial judgments can mask wrongful convictions and acquittals then, analogously, inadequately reasoned judgments in account reviews can mask biased

and unfair outcomes. This kind of transparency problem would be more pressing where there was a high degree of reliance on the part of the client as well as conflict of interest.

There are a number of reasons, therefore, to regard the client/ representative relationship in the context of internal account reviews as being problematic. The representative has sole responsibility for determining the outcome in this relationship. In view of this, the relationship may be characterized as 'Decided-For-You'. There is potential conflict of interest in that "no evidence of wrong doing" judgments are associated with financial incentives. This conflict of interest is masked, but not managed, by referring to the review process as an independent, objective, and impartial investigation. Using these terms leads the client to view the outcome as fair, yet the client is unable to verify this. The way the decision is communicated to the client does not reflect the compliance-type judgments that supposedly were made in reaching it. More generally, the comments and opinions presented in the written response are inadequately reasoned. This lack of transparency can mask biased judgments and unfair outcomes from the client.

I can appreciate that one of the goals of the Fair Dealing Model is to reduce the number of disputes by regulating relationships at the investment level. Nevertheless, it seems clear that regulating conflict of interest at this level will not per se manage conflict of interest in the context of internal account reviews.

While the client remains free to accept or reject the outcome of these reviews, the client's decision in this regard is not adequately supported by information provided by the representative in the written response. Nor, in my experience, was there any opportunity for discussion or clarification. Even where this is available, if the client's interests have not been properly considered in the judgments that have been made, the client would have to be able to discern this and ask the right questions. It seems problematic to expect that clients should have to defend their interests in this way.

My analysis of this relationship within the framework of the Fair Dealing Model indicates that clients are accepting formally opaque judgments about their accounts in a relationship where there is a high degree of reliance on the decision of the representative together with unmanaged conflict of interest. In view of this, it appears that the relationship in question is objectively impaired relative to the factors that constitute fair dealing. Since clients are vulnerable to harm in such relationships, I believe there are strong reasons for the Ontario Securities Commission to consider stricter standards of business conduct for firms that provide these services.

Although the outcome of my analysis is negative with respect to the relationship in question, it has confirmed the theoretical value of the Fair Dealing Model itself. Working within the framework of the theory, it has been possible to apply the concepts and core principles of the model to considering a further relationship that is not explicitly analyzed in the present concept paper. It has been possible, on this basis, to assess the fairness of business conduct in this relationship in an objective manner and in principle.

On a practical level, I believe the Fair Dealing Model makes an important contribution in proposing standards that align business practices in the investment industry with the values that structure a just society.

Yours truly,

Pamela J. Reeve