



SOCIAL INVESTMENT ORGANIZATION

The Canadian Association for Socially Responsible Investment

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April 24, 2008

Richard J. Corner
Vice President, Regulatory Policy
Investment Dealers Association of Canada
Suite 1600, 121 King Street West
Toronto ON M5H 3T9

Dear Mr. Corner:

Re: IDA PROPOSED CLIENT RELATIONSHIP MODEL

I am writing on behalf of the members of the Social Investment Organization, the national association for socially responsible investment (SRI). Our sustaining and associate members include 36 financial institutions, asset management firms, fund companies, investment consulting firms and credit unions. As well, our membership includes advisors, consultants, lawyers and non-profits from across Canada. Our members are committed to the development of socially responsible investment, which is the integration of social and environmental considerations into the selection and management of investments. Our members serve more than a million Canadian depositors and investors.

With this letter, we are responding to the recent publication of the *Establishment and amendment of IDA rules to implement the core principles of the client relationship model*.

Let me take this opportunity to commend the IDA on this initiative. Recent events such as the ABCP crisis show that the financial industry badly needs to reformulate the bond it has with its clients to better emphasize client disclosure and improve client suitability. We commend your recent initiative on the Client Relationship Model as a major step in the direction of improving the information provided to clients and determining client suitability.

However, we want to raise a matter that we feel is a major deficiency in your model; namely the lack of disclosure of information on, and the assessment of client suitability for, socially responsible investment. We believe that the demand for socially responsible investment by the investing public is much larger than is reflected in current assets, and this gap between potential demand and current assets is the result of an outdated model of client relationship based solely on financial considerations. We believe that the majority of Canadians are demanding investments that take into consideration non-financial impacts, as well as traditional parameters of risk and return. Yet the mainstream of the financial industry in Canada has failed to come to grips with this reality, with the effect that Canadians are being poorly served by their investment sector. This is an example of market failure, a key component of which is the failure of most financial advisors in Canada to delve into the attitudes of their clients on this issue.

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While this is obviously a very complex area requiring reform on many levels, we would like to take this opportunity to suggest some simple amendments to your Client Relationship Model that would encourage advisors to re-think their relationship with their clients to better incorporate non-financial issues.

Background

The incorporation of social and environmental issues into investment decision-making has been growing at a fast pace in recent years. In the US, a study released in March by the US Social Investment Forum (*Report on Socially Responsible Investing Trends in the United States*, <http://www.socialinvest.org/news/releases/pressrelease.cfm?id=108>) found that SRI assets increased more than 18 per cent between 2005 and 2007 to \$2.71 trillion. This compares with conventional asset growth in the same period of less than three per cent. In Europe, the European Social Investment Forum estimates that the broad European SRI market is now 1 trillion euros, representing between 10 and 15 per cent of total European funds under management. This represents 36 per cent growth since 2002 (*2006 European SRI Study*, http://www.eurosif.org/publications/sri_studies).

In Canada, our own study (*The Canadian Socially Responsible Investment Review 2006*, <http://www.socialinvestment.ca/documents/SRIReview.pdf>) found \$503 billion in assets managed under SRI guidelines, a major increase from \$65 billion in 2004. In the Canadian instance, the growth was driven by the adoption of SRI policies and practices by major public pension funds, including the CPP Investment Board, the Caisse de depot et placement du Quebec and the BC Investment Management Corp.

As you can see, investors in Canada and around the world are becoming increasingly interested in environmental, social and governance (ESG) considerations in securities selection and portfolio management.

This has been prompted by recent concerns with climate change, as well as long-standing awareness of issues such as sweatshop labour, product safety, employee relations, and a host of other social and environmental concerns. It is clear that Canadians want investments that reflect their concerns not just as investors, but as members of families and communities, and their values as citizens and consumers in the world.

This has been borne out by many studies on investor attitudes during the last few years. For instance, in Canada, GlobeScan has conducted a number of investor attitude studies on a host of topics, including the views of retail investors on the social responsibility aspects of their portfolios. (For a summary of this research visit http://www.socialinvestment.ca/SIO_pres_GlobeScan_.pdf) This research reveals:

- Nearly nine out of ten investors believe the financial community should pay more attention to social and environmental performance when valuing companies
- More than nine out of ten investors agree that corporate CEOs and Boards should monitor the performance of their companies on corporate social responsibility
- More than three-quarters of investors are interested in learning more about the social performance of companies in their portfolio
- More than three-quarters of investors believe that corporate social responsibility reporting is an important factor when making an investment decision

Advisors are not asking about social and environmental issues

Yet, in spite of this overwhelming desire for more information on the social and environmental performance of investments in their portfolios, most Canadian advisors fail to incorporate non-financial considerations into their clients' suitability assessments. Research shows that they fail to take even the first step – which includes an inquiry into their clients' social and environmental concerns. This is illustrated by GlobeScan research showing:

- Sixty-six per cent of investors have not considered or had a discussion with their financial advisor about the corporate social responsibility performance of companies in their portfolio
- A further 11 per cent have considered the issue, but not brought it up with their advisor
- Thirteen per cent have brought the issue up with their advisor, and one per cent said that both they and their advisor have brought it up
- Only eight per cent of advisors have brought it up with their clients.

We believe that this lack of advisor inquiry into social and environmental concerns by their clients represents an important gap in the client suitability assessment process. Just as it is absolutely essential to assess client suitability on issues such risk tolerance, investment horizon and liquidity requirements, it is also absolutely essential to determine client concerns with regard to social and environmental issues, and the interest in socially responsible investment.

There are growing indications that investment fiduciaries that fail to take environmental, social and governance (ESG) considerations into account could be holding themselves open to legal action in the future if it can be demonstrated by clients that failure to incorporate such considerations has led to a loss in the portfolio. This view has received important support from a landmark legal study on this issue completed in 2005 by the UK law firm Freshfields Bruckhaus Derringer for the United National Environment Program Finance Initiative. According to the report, entitled *A legal framework for the integration of environmental, social and governance issues into institutional investment*

(http://www.unepfi.org/fileadmin/documents/freshfields_legal_resp_20051123.pdf), “integrating ESG considerations into an investment analysis so as to more reliably predict financial performance is clearly permissible and is arguably required in all jurisdictions.”

This report clearly focused on the financial implications of social and environmental performance rather than client views on the topic. As well, the report looked at the legal obligations for fiduciaries of institutional rather than individual assets. Still, it shows that legal opinion on this issue has changed, and advisors need to be aware that good fiduciary practice means that advisors should inquire about their client's wishes on social and environmental issues, and incorporate those wishes into their portfolios. This is an important aspect of client suitability.

Model of best policy – Australia

In terms of best policy for the IDA and Mutual Fund Dealers Association on this matter, we commend to you the model in place in Australia, as set out in Regulatory Guide 175, Financial Product Advisors – Conduct and Disclosure, established by the Australian Securities and Investments Commission (ASIC)

([http://www.fido.gov.au/asic/pdf/lib.nsf/LookupByFileName/PS175.pdf/\\$file/PS175.pdf](http://www.fido.gov.au/asic/pdf/lib.nsf/LookupByFileName/PS175.pdf/$file/PS175.pdf)).

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The regulatory environment on socially responsible investment in Australia is the best in the world, supported by a broad consensus among industry associations, ASIC and legislators from different political parties that disclosure on social, environmental and ethical considerations should be mandated. As a result, ASIC has instituted guidelines for such disclosure not only for advisors in their relationship with clients, but in the product disclosure statements of investment funds under ASIC jurisdiction.

In this brief, we look at the disclosure guidelines for advisors, which is of particular interest to IDA in the development of its client relationship model. The guidance to advisors provided by ASIC is set out in regulation 175.110, and is expressed in the context of the general rule on client suitability, as set out in section 945A. Regulation 175.110 reads:

What inquiries about environmental, social or ethical considerations should be made?

RG 175.110 Providing entities must form their own view about how far s945A requires inquiries to be made into the client's attitude to environmental, social or ethical considerations. However, as a matter of good practice (and irrespective of any current legal requirement), providing entities should seek to ascertain whether environmental, social or ethical considerations are important to the client and, if they are, conduct reasonable inquiries about them.

We believe the Australian approach has a lot of value and wisdom. It mandates that inquiries should be made, but does not specify a checkbox approach. It also suggests that the general client suitability rule does pertain here, but leaves it to the advisor to determine the importance of social, environmental and ethical considerations for any given client. This encourages advisors to become engaged with their clients on social and environmental issues, not just to regard this matter as one more compliance requirement.

In the following, we recommend a similar approach to IDA in its client relationship model. We will make a similar recommendation to MFDA when it releases its client relationship model.

Recommendations

Your proposed Client Relationship Model (CRM) does not fit perfectly with the approach we would recommend because the CRM focuses on disclosure rather than best practice on client suitability. However, we believe that the CRM should mandate inquiries into clients' attitudes towards environmental, social and governance (ESG) considerations as part of the assessment on retail client suitability. Furthermore, we recommend specific changes to the account opening procedures mandated in the Know Your Client regulation, now a part of Policies 2, 4 and 9, that will guide advisors in their inquiries on ESG considerations.

Specifically, we would recommend the following:

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- That you add a statement in your CRM document to note the importance of determining environmental, social and governance considerations. Under retail client suitability on page 2, we would add the question: How are my environmental, social and governance concerns incorporated into my portfolio?
- That you add reference to environmental, social and governance considerations in the relationship disclosure requirements on page 6. This could include “A description of the process used by the Member to assess the client’s attitude to environmental, social and governance considerations. This would include the inquiries used to ascertain whether environmental, social and governance considerations are important to the client and, if they are, how they would be applied to the portfolio.”
- Under your new retail client suitability requirements on page 7, that you add a statement clarifying that the client suitability rules with regard to ESG considerations would also come into force under the new trigger events, as stipulated.

Furthermore, we recommend that the Know Your Client policies, as set out in Policies 2, 4 and 9 should be changed to mandate inquiries into the environmental, social and governance attitudes of clients, and that information on clients’ attitudes should be incorporated into the agreements and disclosures available to clients.

If IDA incorporates these changes into your CRM, we will endorse it, and urge securities commissions to approve it.

Conclusion

It is clear that Canadians are demanding disclosure on the social responsibility and environmental sustainability of their investments. Clients are increasingly asking for such information, and the investment industry is responding. Yet, evidence shows that the majority of advisors are not making inquiries into their client’s views on these topics, which prevents them from fully assessing client suitability.

We believe that this is an important gap in the client relationship model. Increasingly, the relationship between advisors and their clients is based on more than just financial considerations; there are growing demands on advisors to take a holistic approach to their clients’ needs and to know their clients in depth.

We urge you to implement these recommendations. Advisors, clients and the general public will benefit from them.

Sincerely,



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