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PHOCION INVESTMENT SERVICES | Two Years Post Regulatory Adoption: CRM2 Implementation Deficiencies Remain

The 2017 year-end investment statements will represent Canadian investors' second set following the industry-wide adoption of the CRM2 transparency requirements that came into force on July 15 2016. Investors should once again pay attention to increased detail regarding total compensation paid to their investment professional in addition to the dollar-weighted performance returns that they achieved. Despite pervasive anecdotes from the field that dealer CRM2 rollout occured without a hitch, the most recent IIROC Notice implies the opposite to in fact be true as they discuss key findings from their surveys.

Total Advisor Compensation Encompasses Direct and Indirect Costs

With respect to total compensation paid by the investor to their advisor, CRM2-compliant investment statements provide granularity about both direct and indirect costs. Pre-CRM2, indirect costs were previously referred to as "hidden costs". These fees represent those paid to the advisor from the issuer of an investment product or a new issue. For instance, it is common practice for structured financial products to be wrought with fees. Though it is the investment advisors' duty to ensure that their clients are aware of the existence of such levies prior to their purchase, this does not always occur. Complete information about fees is described in the prospectus and related tear sheets. An unfortunate notable omission from the advisor compensation report are costs associated with mutual funds (i.e. the management expense ratio - MER).

Long-Term Performance Should Line Up With Return Objective (Net of Fees)

Performance reporting reflects account performance over a disclosed period. With the adoption of CRM2 performance returns must be done on a dollar-weighted basis with a return unique to each investor. Investors need to evaluate whether achieved returns were earned in a cost effective manner. Therefore, total compensation should be compared to invested capital. This level should be reasonable in relation to achieved returns and size of managed assets. Investors should evaluate all actively managed wealth with the low-cost, passive equivalents. Should the former strategy have provided underwhelming returns then on a go-forward basis strong consideration should be given to switch to using products such as index funds and ETFs.

IIROC Highlights Deficiencies

In March 2017, IIROC surveyed dealers on the status of their CRM2 rollout. Challenges identified by dealers in the rollout included: (1) difficulty in allocating fees among client accounts, and, (2) operational constraints when printing reports. In their January 18, 2018 Notice, IIROC continued their articulation of CRM2 compliance concerns, namely: (1) insufficient KYC information on investment time horizon, and (2) insufficient disclosure of charges on a pre-trade basis.

Historically, the investment advisor only had to collect investor financial situation (i.e. investment knowledge, objective and risk tolerance). With the implementation of CRM2, dealers are also required to collect and consider a client's investment time horizon as part of the KYC process. During their examinations, IIROC found dealers failing to collect time horizon information.

IIROC noted many instances whereby dealers did not maintain documented evidence that the required pre-trade disclosure of charges had been made. They also identified instances where dealers lacked policies and procedures governing pre-trade disclosure. This goes against regulatory requirements, which stipulate that retail clients must be informed of all fees associated with an instruction to purchase or sell a security in an account before the trade takes place.

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Closing Remarks

In our February 23, 2016 article titled ‘CRM2: Missing the Mark’. Phocion had stated they thought CRM2 did not go far enough with respect to providing additional transparency especially with respect to performance reporting, the feeling was that the program represented a positive step in the right direction. For that we applaud the Canadian investment industry. Indeed, CRM2 has been implemented and for the most part as been implemented well. However, as IIROC clearly points out enough companies have been surveyed to conclude that deficiencies remain at unacceptably high levels. What is an investor to do? Phocion encourages investors to be diligent in going through the investment statements and seek out an independent opinion if required. As well, make certain to fully comprehend total fees associated with each product before it is acquired. This includes products whose cost are not made transparent as per CRM2 such as mutual funds.

Bibliography:
IIROC Notice 18-0015– Rule Notice – Guidance Note – IIROC Compliance Priorities; January 18, 2018; Pinnington, Harris and Rudd; 1.2. Client Relationship Model (CRM2), 3.4. Client Relationship Model (CRM2).