

WELCOME TO CRM2

In January 2017, clients of Hemisphere Capital Management (HCM) will get their first taste of the Client Relationship Model, Phase 2 (known commonly as CRM2). CRM2 introduces standardized reporting requirements for regulated Canadian financial advisors. Not surprisingly, HCM already meets the bulk of CRM2's reporting requirements. Although well-intentioned, CRM2 will likely create confusion for most HCM clients rather than improve reporting transparency.

CRM2 represents the second component of the Client Relationship Model (CRM) regulatory initiative. Originally called the Fair Dealing Model, CRM was proposed by the various Canadian Provincial securities regulators over a decade ago. After a number of regulatory amendments, the first phase of CRM (CRM1) was introduced in 2012. CRM1 formalized industry best practices for financial advisors related to reporting on new client account types, services and costs, standards for investor suitability and risk levels and comprehensive conflict of interest disclosure.

CRM2 is the result of the collaboration of a veritable “dog’s breakfast” of financial industry stakeholders in Canada. As to be expected, the more powerful industry participants appear to have successfully lobbied Canada’s securities regulators to ensure their interests and those of their members were more “actively” considered. These powerful industry participants include Canada’s oligarchical banks and life insurance companies, self-regulatory bodies such as IIROC (the Investment Industry Regulatory Organization of Canada) and the MFDA (the Mutual Fund Dealers Association) and industry groups connected to these players – i.e. IFIC (the Investment Funds Institute of Canada) and IIAC (the Investment Industry Association of Canada).

CRM2 is based on two core elements: more detailed fee/compensation reporting and standardized account investment performance reporting. As always, the details of the regulations highlight some serious short-comings.

Firstly, many financial products/securities in Canada are exempt from the CRM2 requirements. These include insurance products (i.e. segregated funds), guaranteed investment certificates (GICs), certain real estate and mortgage investment products and bank-sponsored principal-protected notes (PPNs). Additionally, many financial advisors in Canada are dual-licensed such that they would deal in both CRM2 applicable products/securities and CRM2 exempt product/securities. This scenario could clearly create potential conflicts-of-interest at the client level.

Secondly, fee reporting for CRM2 is primarily focused on fees paid to the financial advisor’s firm and does not include other administrative or advisory fees related to a financial product/security. For HCM clients who are charged a fee based on a percentage of assets under management, this is not an important issue. However, for investors using independently sourced mutual funds or other managed products, this is a real deficiency of the CRM2 initiative. For example, in the case of a Canadian investor owning \$10,000 of a mutual fund with a typical management expense ratio (MER) of 2.5% which includes a trailer fee of 1.25%, only the 1.25% or \$125 attributable to the trailer fee is reported under CRM2. The other 1.25% or \$125 is not reported – it is not part of the CRM equation. It is also important to note that of the reported 1.25% or \$125, only \$100 or so would be paid to the financial advisor. The remaining 20% or \$25 is paid to the firm, but this breakdown is not provided under CRM2.

For financial advisors or brokers working within a bank and selling bank managed mutual funds or similar products to clients, the CRM2 reporting of fees appears to be vague. Since the bank manages, administers and markets these internal products, how does the bank go about equitably determining the “fees paid to the financial advisor’s firm”? From an objective perspective, there appears to be an incentive for the bank to report lower “fees paid to the financial advisor’s firm” (thereby lowering the amount that must be broken out under CRM2 requirements) than is the case for comparable independent firms. So, despite the fact that the MER for the bank product might be an equivalent 2.5%, CRM2 reporting could give the impression that the bank products cost less. In the end, investors will still need to “read the fine print” and perform their own calculations if they want a complete picture of the fees they’re paying.

A third issue with CRM2, and probably the most serious, relates to the reporting of investment performance. HCM is a strong proponent of standardized investment performance transparency for Canadian investors. We have been reporting investing performance since our inception in 1993. In fact, recently we completed an extensive (both time-wise and money-wise) audit of all historical client investment returns.

As holders of the Chartered Financial Analyst (CFA®) designation and long-time members of the CFA Institute, the world’s largest association of investment professionals, HCM’s portfolio managers adhere to the CFA Institute’s *Code of Ethics and Standards of Professional Conduct*. Moreover, as CFA charterholders we strive to comply with the CFA Institute’s Global Investment Performance Standards (GIPS®) when reporting investment returns to clients. GIPS® requires that all investment return calculations be conducted utilizing a time-weighted return (TWR) calculation. TWR is the most rigorous method of calculating investment returns – hence why it is utilized in the GIPS® standards and why it is used in HCM’s investment performance reports.

To our extreme frustration, CRM2 requires investment performance to be calculated using a money-weighted return (MWR) calculation. MWR is a substantially more simplified (and less accurate) method of calculating investment returns. Furthermore, MWR is very sensitive to the size and timing of cash contributions and withdrawals and, as such, is more prone to “calculation discretion”. Ultimately, the MWR calculation requirement means that HCM clients must now receive a second investment performance report. Clients will inevitably find this quite confusing.

In summary, CRM2 may be well-intentioned, but the “value added” to HCM clients is open for debate. Nevertheless, CRM2’s introduction means HCM clients will begin receiving mandated fee documentation and additional performance reports once annually. The first of these will be delivered in early 2017 and will cover the 2016 calendar year.