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Mr. Richard J. Corner
Vice President, Member Regulation Policy
Investment Industry Regulatory Organization of Canada (IIROC)
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Dear Mr. Corner:

Re: “Book Cost” Definition for CRM2 Purposes

We write to continue the discussions had at the most recent CSA/SRO/Association CRM2 Forum (the “CRM2 Forum”) on October 16, 2014 on the complications posed by the current definition of “book cost” under the CRM2 reporting regulations.¹

We understand that the intention of the CSA, IIROC and the MFDA in requiring dealers and advisors to report on “position cost” is to provide investors with a rough number against which they can compare a current market value to get a sense of whether they have made or lost money on individual positions they hold in their account, on a quarterly basis. We appreciate the regulators’ efforts to avoid leading investors to the view that the position cost information reported on by dealers and advisors is intended to be used as a cost for tax purposes. However, we are concerned that the existing definition of “book cost” will lead to significant and unintended negative consequences for investors.

Below, we set out the difficulties that our members have identified with the existing definition of “book cost”. We conclude by offering a revised definition that would avoid the negative investor implications of the existing regulation. We have discussed this revised definition with our members and they are

¹ Our reference to the cost and performance reporting regulations (or the “CRM2 reporting regulations”) refers to the Canadian Securities Administrators’ (CSA’s) amendments to National Instrument (NI) 31-103, and those of the self-regulatory organizations (SROs): IIROC’s amendments to Rules 29, 200 and 3500, and the Mutual Fund Dealers Association’s (MFDA’s) amendments to its rules (as yet to be published).

supportive. We have also discussed this issue with the Portfolio Management Association of Canada (PMAC), whose membership expressed a concern similar to that of our members at our recent CRM2 Forum meeting. Like the IIAC, PMAC and the Federation of Mutual Fund Dealers (the Federation) also believe that the definition of “book cost” should allow flexibility for investor-directed adjustments and/or transfers and avoid the need to overwrite or purge data that investors have provided or may use.

Problems with Existing Definition of “Book Cost”

Many of the IIAC’s members already provide book cost information to their investors as part of their service. We expect that the majority of our members would prefer to report book cost – as opposed to original cost – once the CRM2 account statement amendments are implemented in July 2015.² We believe that reporting book cost is consistent with investor expectation and preference, as it was the result of investors’ requests that many of our members initially began reporting book cost. While it is in investors’ interests to continue to receive reporting that they are familiar with and expect, our members may no longer be able to provide this information as a result of the new “book cost” definition.

The IROC definition of “book cost” in the CRM2 regulations is:

“book cost” means:

- (i) In the case of a long security, the total amount paid for the security, including any transaction charges related to the purchase, adjusted for reinvested distributions, returns on capital and corporate reorganizations; and
- (ii) In the case of a short security position, the total amount received for the security, net of any transaction charges related to the sale, adjusted for any distributions other than dividends, returns of capital and corporate reorganizations.

Our members’ concern with this definition is that it is very prescriptive; and may not account for a number of other adjustments that may be made to a book cost value. For example, an investor may advise that an adjustment to book cost should be made due to the application of the *Income Tax Act* (Canada) to the investor’s particular circumstances. We believe that it would be contrary to investors’ interests to prohibit this conduct. While the regulators did not intend that investors use book cost for these purposes, doing so is a legitimate investor choice, as a security’s tax position is a reasonable factor for an individual investor to consider when assessing whether to sell or continue to hold the security. A book cost amount that has been adjusted to reflect an investor’s personal circumstances also leaves the investor with a basis – possibly in his or her mind a better basis – for measuring the quantum of a gain or loss.

Our members will often adjust a book cost value at an investor’s request on the basis of the investor’s particular circumstances. The new definition of “book cost” creates two issues, neither of which we

² NI 31-103, s. 14.14.2 and IROC Rule 200.1(a) and (b), and 200.2(d)(ii).

believe was intended when the regulations were drafted: (1) it may force dealers to purge or overwrite all the book cost information they have been reporting to investors to date; and (2) it may prohibit dealers from providing investors with reporting that meets the latter's needs in the future, as elaborated on below.

(1) Regulations May Require Dealers to Purge/Overwrite Existing Data

As noted above, there are many reasons a dealer may adjust an existing book cost value, either at an investor's particular request, by the dealer as a result of a change occurring with the issuer, or as a result of information provided by a preceding dealer. Not all of these reasons are reflected in the existing regulatory definition of "book cost". Even assuming our members have tracked all instances where an existing book cost value has been adjusted, given the number of accounts and the number of positions at any given dealer, it is simply impossible for many of them to be certain that the book cost information they currently report meets the new definition in all cases. The requirement in IROC Rule 200.3 that market value be used for "all investors of the firm holding that security" in cases where book cost for a single investor does not accord with the regulatory definition simply compounds the problem.

Without the certainty that existing information meets dealers' new regulatory obligations, some of our members have said that they will have no choice under the existing regulations but to purge or overwrite all of their existing book cost (including historical market value as book cost data) and reset all investors to market value as at July 15, 2015, or an earlier date. The impact this will have on investors cannot be understated; whether our members intend it or not, some investors (and/or their accountants) rely on their book cost information. They track it closely and request it be adjusted to meet their circumstances. It is precisely these investors who will be most harmed by our members' being forced to purge or overwrite their existing data as a result of the new regulations.

(2) Regulations Will Prohibit Dealers from Meeting Investor Needs

A further unintended consequence of the prescriptive definition of "book cost" is that it will lead to dealers refusing to adjust investors' book cost values at an investor's request. If dealers are required to only report a book cost that meets the existing definition, they will be forced to refuse requests from investors who want to see the book cost value for a particular security adjusted. This restriction limits dealers' ability to provide excellent service to their investors and, more importantly, does not meet regulatory aims of CRM2 in promoting clear and transparent communication between dealer and investor, and active engagement by investors in their investments. Moreover, it may increase the costs to investors of any tax professionals engaged by these investors for income tax preparation purposes.

We understand that as a potential solution to this issue, it has been suggested that our members simply build additional system infrastructure to provide clients with an additional field on all monthly statements that in order to report a book cost that meets the definition under CRM2, in

addition to the current book cost field that many of our members currently provide. It has also been suggested that our members could simply suppress the “non-regulatory” book cost when it did not differ from book cost that meets the definition under CRM2. These approaches would not be helpful for clients. In our view, these options would not address our concerns or meet the aims of the regulation for two reasons.

- First, even with the clearest of disclosure, it will be exceedingly difficult for our members to provide clients with an explanation as to why regulators are requiring the dealers to provide a second separate, and in some cases different, book-cost number in addition to their market value information per security.
- Second, it is difficult to see how this proposal would meet the regulators’ aim of providing investors with a basis for comparison on their security positions, as it will be difficult for clients to understand which book cost field they should be using for these purposes.

As well, it is difficult to conclude that developing and testing new systems to track, manage and store a new, separate field of information would be completed in the next eight months given all of the other mandatory regulatory changes our members are working on.

Proposed Revised Definition

In the interests of assisting the regulators to address what we believe are unintended consequences of a set of very complex requirements that seem to be go beyond what has been described as the principles basis for CRM to overly prescriptive rule in this instance, our members have been working to identify a solution. We understand the principle that regulators are working toward is to allow investors to compare the value of their securities at two points in time. A necessary implication of this is that changing existing book cost information to a new and largely irrelevant number (market value as at July 15, 2015) will be difficult for investors to understand. The simplest way to achieve the regulators’ intention without making the investor worse off is to allow book cost to be adjusted as necessary, with the exercise of a Dealer Member’s professional judgement under standard security controls that restrict the ability to change a client’s data and provide an audit trail of any such changes. We offer the following proposed new IROC definition of “book cost”:

200.1.(a) “book cost” means:

- (i) In the case of a long security position, the total amount paid for the security, including any transaction charges related to the purchase, adjusted for reinvested distributions, returns of capital, and corporate ~~actions reorganizations~~; or
- (ii) In the case of a short security position, the total amount received for the security, net of any transaction charges related to the sale, adjusted for any distributions (other than dividends), returns of capital, and corporate ~~actions reorganizations~~; and
- (iii) In the case of either a long security position or a short security position, an amount as described in (i) or (ii) that may be adjusted by the Dealer Member to reflect:
 - (A) legislative or regulatory tax amendments;

- (B) the request or consent of the investor according to an election under applicable tax legislation; or
(C) cost information provided by a Delivering Dealer Member or other transferor upon transfer of a security position.

This definition will address client data and transfer concerns. Dealer Members are not able to conduct the same verification processes for values that have been provided to them on a transfer in as they are for internal book cost adjustments, given that the particular transaction or adjustment that gave rise to the value occurred outside their control. It would be a disservice to clients if all transfers automatically resulted in the use of market value by the Receiving Dealer Member as a result of not being able to rely on the client's historical book cost number that may have been transferred. Dealer Members should have the option to rely on the book cost provided by a Delivering Dealer Member or other transferor, particularly as once these regulations are implemented, all Dealer Members will be applying the same, standard definition of book cost.

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In conclusion, we are not suggesting that the requirement to report "book cost" be dispensed with. We recognize the value to investors of being able to easily assess the performance of individual security positions over time. In many cases, there will be no need for either investor or dealer to adjust the value being reported. The proposed definition maintains the requirement that book cost be reported in order to give investors the benefit of being able to assess performance on a security-by-security basis, but retains greater flexibility (and accuracy from an investor's perspective) to avoid the unintended consequences that may otherwise lead to severe negative investor impacts.

Moreover, we believe that the proposed definition resolves the current dilemma dealers face regarding the need to purge or overwrite existing data in order to comply with the "book cost" requirements. Historical data would be compliant with this definition of "book cost". In addition to the definition change, we recommend that IROC issue an FAQ to provide clarity on this issue.

We believe that this new definition meets the spirit and principles of CRM2. We would be happy to discuss ways that this new definition could be implemented at your earliest convenience.

Yours sincerely,

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Katie Walmsley and Julie Cordeiro, PMAC
Sandra Kegie, The Federation
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