



## INVESTOR PROTECTION POLICY, DRAFT

February 5, 2017

A well-regulated investment industry is critical for Canadians to be able to effectively manage their investments and plan for retirement. Investor protection, market integrity and an efficient system of capital formation are integral goals for investment industry nationally.

Recent studies have demonstrated that Canadian investors are highly vulnerable due to low financial literacy, investor overconfidence, blind trust in investment advisors and the search for a high yield in a low-interest environment.<sup>i</sup> Many think of outright fraud, but the more pressing problem faced by Canadian investors is the inefficient system fraught with conflicts of interests that is completely legal. Canadian investors lose more money to registered "advisors" than they do to those engaging in fraud.<sup>ii</sup>

CARP seeks legislative and regulatory change to increase investor protection. Specifically, CARP calls for:

1. Increased transparency of all fees paid by investors;
2. Investment advisors to be required to act in the investors best interest, not simply a suitability standard where an advisor's interests may come before an investor;
3. Titles and designations should be regulated to reduce the myriad of existing titles and to ensure that investors understand the difference between various titles, and
4. Enforcement against unscrupulous financial advisors and banks must be meaningful. "Recommendations", without more is inappropriate as is the inability to be able to collect fines imposed against financial advisors.



## **CARP Calls for Increased Transparency for Fees to Advisors**

Common fees associated with investments include:

1. Sales Charge Fees: These are sometimes referred to as “loads” and are a charge when investors buy or sell shares of a fund. They can be “front-loaded”, meaning the investor pays a fee up front upon purchase or “back-loaded”, meaning the investor pays a fee when the shares are sold. Some investments are advertised as low load or no load (which can be deceiving as sales charge fees are only one type of fee). In “fee-based accounts”, the investor does not typically pay sales charge fees but rather pay what is called a “client advisory fee” and is a percentage of the investor’s investment each year.
2. Management Fees and Operating Expenses: Funds pay management fees and operating expenses. These are not paid by the investor directly, but rather are paid by the fund. The ratio of these fees relative to the fund size is called the Management Expense Ratio (MER). While investors do not pay these directly, they still directly impact investors because they reduce the fund's return to investors. MERs vary significantly from lower than 1% to in excess of 3%. Even a small difference, however, can translate into large differences in returns.
3. Trailing Commissions : Some mutual funds pay a commission to the company or advisor who sold the investor the fund each year. The commission is typically paid as long as the investor continues to hold the fund. This is not simply a payment from the fund to the advisor that does not impact the investor. Trailing commissions are paid out of the fund’s management fee and so increase the MER, which as explained above, reduces the return to investors. Trailing commissions typically range from 0.25 percent to 1.5 percent of the value of the investor’s total investment in the fund each year.



When it comes to fees and expenses associated with investments, Canada ranks among the worst in the world according to a recent study.<sup>iii</sup> Canada has some of the highest mutual fund fees in the world. The average equity mutual fund fee in Canada was 2.1% - that is six times higher than the average pension plan fee.<sup>iv</sup> Many fees are embedded into investment products and investment advisors receive a commission from the fund – sometimes unbeknownst to the investor.<sup>1</sup>

The vast majority of retail mutual funds are distributed by advisors who are compensated via trailing commissions that are embedded into the management fee.<sup>v</sup> In a recent study, only 38% of investment advisors in Canada indicated that their clients understand their compensation structure.<sup>vi</sup>

One might think that the high fees are worth it in terms of increased value, but this may not be the case. A recent study demonstrated that investment advisors influence investors decisions but, on average, result in a loss rather than an added value when compared to passive investment benchmarks.<sup>2 vii</sup> In other words, the excessive fees are not worth it from a value-perspective.

The CEO of a large investment research firm claimed that investment fees in Canada are so high because investors do not seem to care.<sup>viii</sup> CARP believes it is more likely investors are unaware of the extensive fees they are paying.

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<sup>1</sup> Methods of compensation vary across investment advisors. Some advisors are commission-based, meaning that they are paid a commission for each transaction, some advisors are fee-based, meaning they charge a fee per year which is usually percentage of the investor's total investable assets, and some are fee-only advisors, meaning they charge an hourly fee or a fixed fee and accept no compensation or commission from any other sources. (Source: Onus Consulting Group. (2009). *Enhancing the Client-Financial Advisor Relationship*. Located online at [[http://www.onusconsultinggroup.com/uploaded\\_files/InvestorAwarenessBooklet.pdf](http://www.onusconsultinggroup.com/uploaded_files/InvestorAwarenessBooklet.pdf)])

<sup>2</sup> Active management occurs when the investment portfolio is actively managed by an advisor with the goal of outperforming a benchmark. Passive management, on the other hand, are index or exchange-traded funds with generally less trading and transaction fees.



The Canadian Securities Administrators (“CSA”) has recently implemented a second round of changes to the Client Relationship Model that will increase transparency. This is known as CRM2. While a step in the right direction, this model does not go far enough in that it does not explicitly breakdown the management expense ratio to be very specific on the amount of trailing commissions. Why the CSA would not take this very necessary step is puzzling.

CARP calls for increased transparency so that investors see every fee they pay, whether embedded or not. Hopefully, transparency and awareness of very high fees will lead to a reduction in this fees that would bring Canada into line with comparable countries. If not, maximum caps on fees should be explored.

### **CARP Calls for the Imposition of an Overarching Best Interests Standard that All Investment Advisors across the Country should be Held To**

Most regulatory agencies impose a standard on investment advisors that has been coined "the suitability standard". Advisors must ensure that the product sold to an investor is suitable at the time of investment based on the advisor's knowledge of the product and the investor. A suitable product is often not the best product for the investor. The result is a regulatory system that condones the failure to act in the best interest of the investor.

This problem is enhanced by the fact that the majority of CARP members, and Canadians for that matter, believe that their investment advisor is acting in their best interest. In 2011, the former Chairman of the Ontario Securities Commission, Ed Waitzer, made the following statement:



“If the product sold is that of advice, then that advice should be in the best interest of the client. Anything else is fraud, because the seller is delivering a service different from what the consumer thinks he or she is buying.”<sup>ix</sup>

Investment advisors may sell products that contain embedded commission for the advisor. When this product is merely suitable for an investor, but not the best product available, the investor is acting in their own best interest for a higher commission to the detriment of the investor. One well-known consultant in the financial services industry put it best when he stated:

Under a suitability standard, mutual funds and other such investments that can't compete on quality, can and do compete by offering generous remuneration to the sellers, and that's the problems...Investors end up paying high costs, suffering substandard performance, being exposed to unnecessary risks and subjected to exploitive behaviours as a direct result.

Trailer fees are often used by funds to compensate an investment advisor for as long as the investor remains in the fund.<sup>x</sup> These fees provided an incentive to recommend the fund over another fund that might be best for the investor but that has a lower trailer fee.

CARP calls for the creation of a best interest standard, also known as a fiduciary duty, requiring investment advisors to act in the best interests of investors. If investment advisors want the privilege of portraying themselves to be “trust advisors” they need to live up to the standard that warrants that level of trust.



British Columbia has long opposed a best interest standard, arguing that it would create legal uncertainty.<sup>xi</sup> CARP believes this position is without merit. Investment advisors are better positioned to cope with uncertainty than the victims of poor investment advice. 97% of CARP members and 93% of Canadian investors support the imposition of the best interest standard.<sup>xii</sup>

### *Unique Vulnerability of Senior Investors – Know Your Client*

Investors are accumulating increasing debt in recent years and as a result are becoming increasingly unable to recover from poor investment advice, bad investment products, and excessive fees and expenses. The average household in Canada holds an average of \$1.65 in debt for each dollar they earn after tax.<sup>xiii</sup> The problem is more pronounced for CARP's members, many of who are retired and lack the options that some younger investors who are actively working may have to recover.

Seniors face other challenges requiring increased investor protection. A recent study demonstrated that the ability of the elderly to manage their money decreases after they reach retirement age, but their confidence in their ability to make good financial decisions remain the same.<sup>xiv</sup> The vulnerability is apparent.

The problem is heightened when one considers the simple fact that seniors are forced to become more dependent on their personal savings in retirement. The other pillars of an effective retirement savings system are in a state of disrepair. Workplace pensions are becoming a thing of the past. 2/3 of Canadians do not have access to a private workplace pension plan. It is even worse for millennial – 3/4 of younger workers between the ages of 25 and 34 do not have access to a private workplace pension plan. CPP is not filling this gap, with the recent changes set to replace approximately 33% of pre-retirement income.



Understanding the investor's unique situation should be the primary focus of investment advisors. Assessing suitability is more than a mechanical exercise of box-ticking. Rather, it involves meaningful dialogue with the investor to garner a solid understanding of their financial situation and objectives. It has been reported that some advisors have their clients sign blank forms, called Know Your Client forms that are often filled in well after investment decisions have been made.

Know Your Client forms should be completed wholly prior to any investment advice being provided and a member of management in an investment firm should be required to sign off on this form in advance of the dispensing of advice. The information received should be subject to a best interest standard (discussed in greater detail below).

### **CARP calls for Regulation around the Designations and Titles Advisors can Use so Investors Understand the Difference**

The issue of low financial literacy is heightened by the significant number of professional designations<sup>3</sup> for financial advisors, accreditation/regulatory bodies, and associations. The majority of CARP members are unable to distinguish between these various designations. Some of these titles do not have any legal standing and the standards of proficiency across the designations varies significantly. For example, some designations require years of work while others can be obtained in a weekend or through online study.

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<sup>3</sup> For example, some of the more common designations found within Canada include: (1) Financial Management Advisor (FMA), (2) Certified Canadian Investment Manager (CIM), (3) Derivatives Market Specialist (DMS), (4) Fellow of the Canadian Securities Institute (FCSI), (5) Chartered Profession (Ch. P), (6) Certified Financial Planner (CFP), (7) Registered Financial Planner, (8) Certified Investment Management Analyst (CIMA), (9) Chartered Financial Analyst (CFA)



CARP calls upon regulators to develop a list of approved titles that are descriptive of the regulated activities and further calls for the prohibition of titles that are not approved and regulated, which leads to confusion amongst investors and are often misleading.

Some professionals who use the title investment advisor are in fact not licensed. CARP encourages investors to research the designation or license of their particular advisor. The Investment Industry Regulator Organization of Canada maintains a database where investors can look up their investment professional. It can be accessed at the following link:

<http://www.iiroc.ca/investors/knowyouradvisor/Pages/default.aspx>

Once an investor has identified the designation used by their investment professional, they can look up what that specific designation means at the following website:

<http://www.iiroc.ca/investors/UnderstandFinCert/Pages/default.aspx>

### **CARP calls for Legislative Reform to Enable the OBSI to Enforce Decisions against Unscrupulous Banks as Opposed to simply making “Recommendations”**

The Ombudsman for Banking Services and Investments (“OBSI”) provides consumers with an alternative to an expensive and intimidating legal system that often favours the party with the deepest pockets. The OBSI operates independently from investment firms and claims to be impartial. The OBSI’s power is limited to “recommendations”. The OBSI’s website makes the following claim:



While we cannot order a firm to follow a recommendation, we have an excellent record of firms – and clients – accepting our suggested resolution. We will make public the name of any firm that refuses a recommendation. The limit for our recommendations is \$350,000...OBSI is not a regulator, and because we are impartial we don't advocate for consumers or the industry. That also means we don't give advice – financial or otherwise. If you don't like our findings in your case, you are still able to go to a lawyer or seek other ways or resolving your dispute.<sup>xv</sup>

Over 65% of the investment complaints received by the OBSI in 2015 involved the suitability of the investment. 55% of the complaints received were from individuals aged 60 and older. While it is refreshing that advisors and firms accept the “recommendation” of the OBSI in some cases, it is not sufficient.

Losing what sometimes amounts to lifetime savings is a terrible experience for an investor. The experience is significantly worsened when the investor discovers restitution is denied or out of reach due to inadequate complaint handling mechanisms.

CARPS calls for a mandatory investigation by the provincial regulatory body whenever an investment advisor or firm refuses the recommendation of the OBSI and make a determination on whether the OBSI recommendation ought to be binding upon the advisor or firm. CARP also states that the recommendations of the OBSI should be made public.

From 2011 to 2015, the Investment Industry Regulatory Organization of Canada (“IIROC”) received 6255 complaints. Of these, IIROC initiated 245 investigations.<sup>xvi</sup> This amounts to an investigation rate of 3.8%.

CARP finds this investigation rate to be wholly insufficient and calls upon IIROC to review its investigation mechanism to ensure that it is meaningful



and responsive to Canadian investors who have experienced travesty at the hands of investment advisors IIROC claims to regulate.

### **CARP Calls for Legislative Change in Every Province to Enable IIROC to Be Able to Collect the Fines Levied Against Unscrupulous Advisors**

IIROC currently lists unpaid fines from individual who had been employed by IIROC-regulated firms at \$27,941,793.00.<sup>xvii</sup> The problem is that IIROC does not have the tools it needs to collect these fines and deter unscrupulous advisors who prey upon investors. While IIROC is able to impose fines, they have no legal right to enforce the payment of those fines in most provinces.

Fines are a critical tool to deter unethical behaviour including embezzlement, buying or selling securities for clients without their permission, and recommending high-risk investments to clients who are unable to tolerate losses. But a fine that cannot be collected is meaningless. Advisors who have acted inappropriately are unlikely to pay fines via an honour system. The success rate for collecting fines is very low, in the 10-15% range for most provinces without the ability to enforce fines. In provinces where fines can be enforced, namely Alberta and Quebec, the collections rates are roughly three times higher.

CARP calls for statutory intervention to ensure that each and every province across Canada gives IIROC the ability to collect the fines imposed against unscrupulous investors.



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- <sup>iv</sup> David Macdonald. (March, 2015). *The Feeling’s Not Mutual: The High Costs of Canada’s Mutual Fund Based Retirement System*. Canadian Centre for Policy Alternatives. Located online at [https://www.policyalternatives.ca/sites/default/files/uploads/publications/National%20Office/2015/02/Feelings\_Not\_Mutual.pdf]
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- <sup>vi</sup> Vanguard. (May, 2016). *Upheaval and Opportunity: Insights from Our Global Survey of Financial Advisors*. Located online at [https://www.vanguardcanada.ca/documents/global-advisor-trends-en.pdf]
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- <sup>viii</sup> National Post Online. *Canada Trails Pack on Fund Fees*. Located online at [http://www.financialpost.com/scripts/story.html?id=abf577f4-21d8-4c1e-8111-0da91fe1cd3a&k=15284]
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- <sup>x</sup> Onus Consulting Group. (2009). *Enhancing the Client-Financial Advisor Relationship*. Located online at [http://www.onusconsultinggroup.com/uploaded\_files/InvestorAwarenessBooklet.pdf]
- <sup>xi</sup> Canadian Securities Administrators. (28 April 2016). *Canadian Securities Administrators Consultation Paper 33-404: Proposals to Enhance the Obligations of Advisors, Dealers, and Representatives Toward Their Client*.
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- <sup>xiii</sup> Kivenko, Ken. (19 May 2016). *Proposals to Enhance the Obligations of Advisors, Dealers, and Representatives Toward Their Clients*. Kenmar Associates.
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- <sup>xv</sup> Ombudsman for Banking Services and Investments. *About Us*. Located online at [https://www.obsi.ca/en/about-us]
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