# INVESTOR PROTECTION POLICY

A well-regulated investment industry allows Canadians to manage their investments more effectively and to plan for their retirement with added confidence. Unfortunately, the lack of awareness of fees, the over-investment in funds paying above-average commissions, and the ongoing frustrations experienced by harmed investors trying to resolve disputes with their dealer or secure financial redress all suggest that Canada's investment industry is not as well regulated as it can and should be. Governments and regulators at this time need to prioritize the initiatives necessary to make financial markets safer, less costly and more transparent for Canadian savers and investors.

In the current environment, the financial vulnerability of Canadian investors has too often been exploited and exposed. This victimization is the product of a number of factors, including: a generally low level of financial literacy, often accompanied by unfounded investment confidence; an overly trusting reliance on investment advisors; and, the perilous pursuit of high yield/high risk assets in the current low-interest rate environment, often necessitated by worries about outliving savings.[1] Many commenters associate this vulnerability with a heightened susceptibility to outright fraud, however, Canadian investors regularly lose more money to excess fees paid to registered "advisors" than they do to those engaging in fraud.[2]

The need to improve investor protection in Canada is becoming more compelling with the ageing of our population. While investors of all ages are susceptible to financial fraud and malfeasance, seniors are especially vulnerable. For one thing, seniors do not enjoy the same luxury of time available to younger investors to recover from a significant investment loss. Also, as confirmed in a recent study, the ability of the elderly to manage their money often decreases once they reach retirement age, but the confidence in their ability to make good financial decisions remains the same. [3] The problem has become even more poignant because the traditional pillars of an effective retirement savings system are increasingly unavailable and inadequate thereby forcing seniors to rely more heavily on their personal

---

[1] Kivenko, Ken. (19 May 2016). Proposals to Enhance the Obligations of Advisors, Dealers, and Representatives Toward Their Clients. Kenmar Associates.

[2] Kivenko, Ken. (June, 2016). Misleading "Advisor" Titles. Kenmar Associates Investor Education.

[3] Michael Finke, John Howe and Sandra Huston. (24 August 2011). Old Age and the Decline in Financial Literacy. Social Science Research Network. Located online at [http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1948627]
xv Ombudsman for Banking Services and Investments. About Us. Located online at [https://www.obsi.ca/en/about-us]

savings. CPP is not the answer because, even after the recently announced enhancements, its payout is only designed to replace approximately one-third of pre-retirement income.

These developments are obliging Canadians of all ages to become more disciplined and pro-active savers and investors. In light of this growing personal saving and investment imperative together with the associated risks and challenges that it poses, CARP is committed to advocate forcefully and responsibly for legislative and regulatory changes necessary to make financial markets safer, more transparent and less costly for our members and by extension all Canadians. Specifically, CARP, at this time, is calling for:

1. Investment advisors to be subject to a best interest standard, rather than a suitability standard, and to better ensure that investment advisors place investors' interests ahead of their own;
2. The elimination of embedded commissions (trailer commissions) paid to advisors;
3. The regulation of titles in a manner that will reduce confusion and misrepresentation;
4. Authority for self-regulatory organizations in all provinces and territories to file decisions with the court to better enforce fine payments.

**CARP Calls for the Elimination of Compensation-related Conflicts of Interest by Introducing a Best Interest Standard that puts Small Investors First**

Canadian securities regulators currently impose a " suitability standard" on most investment advisors. This standard requires advisors to ensure that the product sold to an investor is suitable based on the advisor's knowledge of both the product and the investor. However, a suitable product is not necessarily the best product for the investor. According to a recent study by York University Professor Douglas Cumming, when choosing among equally suitable investments, investment advisors are often financially motivated to select the product that pays them the highest commission.[4] When they succumb to this temptation, these advisors are acting in their own interest, to earn a higher commission, and not in the best interest of their client.

This problem is made worse by the fact that 64% of CARP members believe their financial advisor is required to recommend products that are in their best interest and not those that maximize commissions.

[4] Douglas Cumming, Sofia Johan, Yelin Zhang. (19 October 2015). A dissection of Mutual Fund Fees, Flows, and Performance. Located online at [http://www.osc.gov.on.ca/documents/en/Securities-Category8/rp_20151022_81-407_dissection-mutual-fund-fees.pdf]

A best interest standard would require financial advisors to put the interests of their clients ahead of their own compensation. It would not permit an advisor to recommend or sell a high-priced mutual fund — that pays a significant commission — when a more competitively priced suitable alternative is available. Advisors would no longer be able to default to recommending proprietary funds created by their own firm or funds with long-term deferred sales charges and high commissions when cheaper and more flexible suitable alternatives are available.

An overwhelming 89% of CARP members and 93% of Canadian investors support the imposition of a best interest standard.[6] Informed by this unambiguous support, CARP fully endorses the immediate replacement of the current suitability standard with a best interest standard. If investment advisors want to enjoy the status and privilege of "trusted advisors" they need to be held to the standard that warrants that level of trust.

**CARP Calls for Elimination of Embedded Commissions Paid to Advisors**

A recent study calculated the average equity mutual fund fee in Canada to be 2.1% - six times higher than the average pension plan fee.[8] (See Appendix A for further details.)

While Canadian regulators recently implemented the second phase of changes to the Client Relationship Model, known as CRM2, reforms didn't go far enough. Financial firms must only disclose the cost of advice, there is no requirement to disclose the cost of products sold.

In January 2017, Canadian securities regulators published a consultation paper[10] to consider the elimination of embedded commissions, like trailer fees. The consultation paper identified conflicts of interest that misalign the interests of investment advisors and investors as the key investor protection issue posed by embedded commissions. To manage

[6] OSC. (18 March 2013). OSC's Investor Advisory Panel Releases Survey Findings on Adviser/Investor Relationship. OSC Investor Advisory Panel. Located online at [http://www.osc.gov.on.ca/en/Investors_nr_20130318_iap-adviser-investor-relationship.htm]

[8] 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]

[10] CSA Consultation Paper 81-408 – Consultation on the Option of Discontinuing Embedded Commissions

or mitigate this conflict, the regulators suggest direct pay arrangements that would better align interests and provide increased transparency with respect to fund costs. CARP endorses a move to direct pay arrangements and calls for the elimination of embedded commissions, like trailer commissions. Not only will the elimination of trailer commissions reduce the inherent conflict of interest in the current mutual funds sales model but this will also allow investors to more easily understand and control an important cost component of their investments. CARP believes this heightened transparency and control will encourage fee reductions and improve overall returns to clients.

**CARP calls for Regulation of Titles to Reduce Confusion and Misrepresentation**

The challenges already posed by most investors' limited financial literacy are only compounded by the confusing array of titles[11] used by financial advisors.

CARP recommends that individuals working in the investment industry who are not designated by an approved regulatory body must have a title that clearly indicates they are a sales person. For example, an individual might be a mutual fund salesperson, an investment product sales person or an equity sales person. This would not preclude the individual from providing advice about a particular product, but it would more clearly alert the client to the sales nature of the relationship. Non-descriptive and potentially misleading titles such as Vice President, Seniors Advisor or Wealth Management Specialist are not appropriate and should be eliminated. CARP is particularly concerned about unwarranted titles signalling expertise to seniors. CARP calls upon regulators to develop a short list of approved titles that describe clearly the regulated activities that the holder is qualified to provide. In addition, CARP asks for the prohibition of titles that are not approved and regulated, which can be misleading and often simply contribute to confusion among investors.

**CARP Calls for Legislative Change to Increase the Collection of Fines Against Rule Breakers**

In response to representations from key advocates, including CARP, the Ontario government recently announced it will introduce legislation to allow self-regulatory

[11] 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)

organizations such as the Investment Industry Regulatory Organization of Canada (IIROC) and the Mutual Funds Dealers Association of Canada (MFDA) to file decisions with the court. This new power will enhance the ability of self-regulatory organizations to collect fines from individuals they have sanctioned. CARP has consistently argued that while fines are a critical tool to deter unsuitable or unethical behaviour, they are meaningless if they cannot be collected. The fall-out from rule-breakers is particularly harmful to older investors who are unable to make up the losses they suffer from negligent or fraudulent financial advisors.

CARP applauds Ontario's recent decision, but there is more to be done. Only Alberta, Quebec, P.E.I. and Ontario (pending) have legislation in place to enforce fine collection. Other provinces and territories must take similar action to protect investors.

The reforms that CARP proposes are not new, many of them have been under debate for years in Canada and have been adopted by other countries. In this policy, CARP makes the case not only for these reforms, but for these reforms to be made now. There is no rationale for any further investors to suffer losses because of government inactivity.

# Appendix A

The fees typically associated with mutual fund investments include:

1. Sales Charge Fees: These are sometimes referred to as "loads" and are charged when investors buy or sell units of a fund. They can be "front-loaded", meaning the investor pays the fee immediately upon purchase or "back-loaded", meaning the investor pays the fee when the shares are sold. In "fee-based accounts", the investor does not typically pay sales charge fees but instead pays an annual "client advisory fee" that is calculated as a percentage of the investor's average value of investment assets over the year.

2. Management Fees and Operating Expenses: Funds charge management fees and operating expenses. These fees are not paid directly by the investor but instead are withdrawn from the investment fund and as a result reduce investor returns. The ratio of these fees to the value of the assets in the fund is referred to as the Management Expense Ratio (MER). MERs vary significantly from less than 1% to more than 3%. While numerically small, these expenses can significantly reduce investor returns when compounded over many years.

3. Trailing Commissions: Some mutual funds pay an annual commission to the company or advisor who sold the fund, as long as the original investor continues to hold the fund.[12] Ostensibly designed to compensate advisors for the post-sale service they provide investors, these trailer fees have effectively become a commission annuity. They provide advisors with an incentive, when choosing between two alternative suitable funds, to recommend the one with the higher trailer fee. Trailer fees, when paid, are included in the fund's management fee and consequently drive up the MER. As noted above, the higher the MER the lower 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.

[12] Onus Consulting Group. (2009). Enhancing the Client-Financial Advisor Relationship. Located online at [http://www.onusconsultinggroup.com/uploaded_files/InvestorAwarenessBooklet.pdf]