

Kenmar Associates

Dedicated to Investor Protection

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**Comments on OSC Notice 11 -768 Priorities for fiscal year ending March 31, 2014**  
[http://www.osc.gov.on.ca/en/SecuritiesLaw\\_sn\\_20130404\\_11-768\\_rfc-sop-fiscal-2013-2014.htm](http://www.osc.gov.on.ca/en/SecuritiesLaw_sn_20130404_11-768_rfc-sop-fiscal-2013-2014.htm)

Kenmar Associates welcomes the opportunity to comment on the Proposed Statement of Priorities (SOP). Kenmar is an Ontario- based privately-funded organization focused on investment fund investor education via on-line research papers hosted at [www.canadianfundwatch.com](http://www.canadianfundwatch.com). Kenmar also publishes *the Fund OBSERVER* on a bi-weekly basis discussing investor protection issues primarily for investment fund investors. An affiliate, Kenmar Portfolio Analytics, assists, on a no-charge basis, abused investors and/or their counsel in filing investor complaints and restitution claims.

Overall, we'd like to acknowledge the OSC's determined and positive efforts at retail investor protection over a wide spectrum of issues. Establishing the Office of the Investor is unique among Canadian regulators. The financial support for FAIR Canada is a very positive action since the Canadian investor advocacy community is chronically underfunded. We note the emphasis on fact -based decision making and absolutely endorse this approach. The OSC's process for consultation from stakeholders is more than fair and has greatly improved in quality and participation these last two years.

We would like to take this opportunity to recognize [www.Getsmarteraboutmoney.ca](http://www.Getsmarteraboutmoney.ca) website financial educational initiative and the OSC Inquiries Service. The Inquiries service is fast at responding to questions from investors. These are functioning well and merit nurturing and increased stable funding.

The OSC needs to work in partnership with other entities -specifically the MFDA and IROC. It is also necessary that SRO's be required to align themselves with OSC priorities. A disconnect between the SROs priorities for example, with the OSC's priorities, would significantly de-optimize the whole process. These include, but are not limited to: sales communication, Best interests duty, suitability system, disclosure, advisor compensation and the use of titles/designations.

With the evolution of the investment markets, a multitude of structured products and the volatility in today's markets, investor risks and vulnerabilities are much greater than ever before. Canadians are highly vulnerable due to low financial literacy,

information asymmetry vs. dealers/advisors, overconfidence in investing skills, undue trust and a desperate search for yield. Recent high profile scandals, “advisor” abuse and changing demographics (seniors, pensioners and retirees) suggest that investor protection demands HIGH priority attention .Our review of the draft SOP suggests that the OSC, to a large extent, has the appropriate priorities and emphasis.

For the 2013/2014 priorities, we note that the Commission has identified thirteen regulatory priorities. These appear to be the right focus but would add one more: **Seniors Issues**. Abuse of the elderly in particular continues to emerge as a major issue in Ontario as reported by OBSI and others. We strongly recommend the establishment of a Branch dedicated to seniors issues such has been implemented at the U.S. SEC and elsewhere.

Our comments are limited to retail investor issues. We leave it to others to deal with such issues as shareholder democracy, insider trading, HFT, IFRS, reverse takeovers etc. Here are our recommendations regarding retail investor protection priorities for the year ahead:

**1. Establish a Seniors Issues branch:** Senior investor protection is a very critical issue. With the aging population, there will be more and more abuse of seniors by the financial industry .OBSI report that about half of all complaints emanate from those over 60. A recent article *Can regulators stave off 'massive increase in senior misery?'* in Investment News [http://www.investmentnews.com/article/20130409/FREE/130409923?utm\\_source=indaily-20130409&utm\\_medium=in-newsletter&utm\\_campaign=investmentnews&utm\\_term=text](http://www.investmentnews.com/article/20130409/FREE/130409923?utm_source=indaily-20130409&utm_medium=in-newsletter&utm_campaign=investmentnews&utm_term=text) neatly sums up the issue. Mercer Bullard, president of Fund Democracy and professor of law at the University of Mississippi, asserted that the United States is on the verge of a “senior crisis” posed by the risk of seniors' outliving their assets and their declining ability to manage their money as they age. The identical situation exists in Canada. We urge the OSC to gather data from dealers regarding the products they market to seniors, the percentage of revenue they derive from those sales, how advisors are assigned to elderly investors and the designations/titles firms are using to market themselves to older Canadians. Once the data is distilled, appropriate measures need to be introduced. Given that thousands of Canadians each month are retiring/entering into retirement/RRIF's, time is of the essence. This is a major socio-economic issue as well as an important regulatory issue so that the OSC should consider an organizational unit dedicated to dealing with it before a fiasco occurs.

The OSC's plan to better understand the significant issues affecting fixed income securities and those who invest in them ( especially seniors/retirees), and to review its current approach to regulation to determine if any changes are required is a very positive and timely initiative. We agree that issues such as transparency and investors chasing yield in a low interest rate/slow growth environment are a potential source of risk. Please note that Bond mutual fund risk ratings are based on historical volatility and thus may not be properly risk rated in Fund Facts.

**2. Decide on Best interests et al:** The SOP states “*Work with investors and SROs to examine and better understand the impact of imposing a best interest duty on dealers and*

*advisers*”. We respectively suggest that the impact on Ontarians of NOT imposing a best interest duty also be undertaken. The status quo is not, in our view, a viable option. No discussion of investor protection issues and the costs of transactions/advice can be complete without discussion of the broker and investment dealer business model. We recommend a Roundtable dedicated to this subject be planned as soon as possible, similar to the one on mutual fund fees. Following this, we would hope that regulatory changes would be introduced without undue haste or delay. Time is of the essence.

A recent Mutual Fund Dealers Association Bulletin <http://www.mfda.ca/regulation/bulletins13/Bulletin0563-C.pdf> set out the SRO's regulatory priorities. These include excessive leveraging, blank signed forms, document adulteration, marketing materials and seniors issues, particularly suitability. The 2011-2012 IIROC Annual Report comments that the issue of unsuitable trade recommendations “is a persistent and significant problem in the Canadian investment industry”. When this information is coupled with asymmetric advisor-client information and advisors with conflicts-of-interest compensation arrangements, an unsafe investment environment results. Excessive fees and skewed advice combine to effectively reduce the ability of Canadians to save for retirement.

It is glaringly evident that investment advice robustness needs to be dramatically improved and therefore made a 2013-2014 OSC priority. We recommend the OSC move away from the transaction model and pursue a fiduciary / Best interests regime for advisors without undue delay. Embedded commissions should be prohibited. This is well underway in the UK, US, Australia and in other jurisdictions. As professional financial advisor and author John Decoy has noted in his recent Mutual Fund Fee Comment letter, the advantages of prohibition are numerous and include:

- <sup>35</sup><sub>17</sub> Transparency- investors will understand very well that neither mutual funds, nor advice associated therewith is “free”.
- <sup>35</sup><sub>17</sub> Cost arbitrage- both advisors and investors will be able to substitute higher-cost products with lower-cost products (including, but not limited to, other mutual funds).
- <sup>35</sup><sub>17</sub> Exploding the myth that both mutual funds and the advice associated with them is “free”
- <sup>35</sup><sub>17</sub> Allowing for potential [ tax] deductibility depending on the nature of the account
- <sup>35</sup><sub>17</sub> Removing the potential of compensation-induced bias- both within and throughout product lines
- <sup>35</sup><sub>17</sub> Enhancing consumer confidence in both advisor motives and the actual advice given
- <sup>35</sup><sub>17</sub> Improving consumer understanding of the constituent component parts of mutual fund costs
- <sup>35</sup><sub>17</sub> Allowing for scalability of fees (a so-called ‘volume discount) as accounts grow

Canadian retail consumers need increased protection when dealing with the financial planning industry, according to a report released March 26, 2013 by the Public Interest Advocacy Centre (PIAC) entitled, *Purse Strings Attached: Towards a Financial Planning Regulatory Framework*. The report reveals that some progress has been made in recognizing the need for reform. However, the pace of this process has been slow for an industry entrusted with the financial security of Canadian consumers. “It’s time all employees of the financial planning industry in Canada face the reality-they need to

employ a uniform standard of care for investors, complete with a full disclosure of how they're being compensated," noted Jonathan Bishop, co-author of the report. The research reveals Canadian consumers are potentially leaving thousands of their retirement dollars in someone else's hands by not being fully informed. The report concluded that the time remains ripe for provincial consumer and finance ministries to work towards a regulatory framework for financial advisors. Report at [http://www.piac.ca/files/pursestrings\\_attached\\_final\\_for\\_oqa.pdf](http://www.piac.ca/files/pursestrings_attached_final_for_oqa.pdf)

All this has been discussed and debated going back to the classic Stromberg reports of the mid and late nineteen nineties. It's time to regulate the advice side of the investment business. Judging from the public comments on the Best interests and Mutual Fund fee consultations, it's no mystery what Ontarians need and want. We hope that 2013-2014 will finally see some closure on the commission vs. fee issue.

Related to Best interests is the use of improper titles and designations within the investment advice industry. They mislead retail investors into a false confidence. There are far too many advisors, Vice Presidents, money mentors, Seniors Specialists etc. that are really just salespeople. We'd like to see the OSC rein in these misleading monikers.

We generally support the OSC's plan to use mystery shopping as a methodology to obtain on the ground information on industry sales practices. A 2012 shopping exercise by the UK FSA turned up some serious issues regarding suitability. It found that in one quarter of banks and building societies investigated, the advice given was poor. A Feb., 2012 CBC's *Marketplace* report looked at Canada's five biggest banks - CIBC, Royal Bank, Toronto-Dominion Bank, Bank of Montreal and Scotiabank - and found most offer little clarity on how mutual fund fees work and how much they cost. As part of its investigation, *Marketplace* used hidden cameras to record investment advisers at different banks and analyze the quality of information given to clients. After reviewing the information from each bank, only one representative gave a clear explanation of fees.

**3. Deal with Mutual fund industry issues** A significant proportion of retirement savings has been, and continues to be channeled into the mutual fund sector in Canada. Because of embedded commissions and other factors, Morningstar gave Canada's fund industry an F grade (the lowest rating) in a 2011 global ranking for having the highest fees among the 22 ranked countries. It was the only country on the list to receive an F.

It's time for more action and less contemplation- Ontarian retirement savings and nest eggs are at risk. The ability of the financial services industry to turn retirement savings into future retiree wealth is an important public policy issue. We argue that it is an urgent one. The OSC Action plan culminates with "Identify *options to move forward and publish a progress update*". Nearly a trillion dollars is invested in mutual funds. More and more seniors and pensioners become vulnerable each day, quarter and year that the status quo remains entrenched that a low suitability standard coupled with fund company paid commissions permit. Given the massive research available on this subject we recommend stronger action language than issuing a progress report

Andrew Teasdale in his refreshingly frank Comment letter on mutual fund fees said:

*“It has been my contention for some time that regulators in Canada are looking to bolster regulation of the transaction based service model as opposed to promoting and regulating advice led service processes which would require a change in industry focus and structure and an overhaul of regulation. This means retaining current suitability standards and investor responsibility. Disclosure and education, aimed at bolstering investor responsibility for the transaction, appear to be the main tools of tighter transaction based regulation.*

*There is, in my opinion, a general failure by regulators to fully appreciate and acknowledge the importance of good advice and the extent to which investors must necessarily rely on their advisors. The market place has been allowed to make "advice based service representations" that imply fiduciary type best interests standards while taking advantage of minimum standards regulation to avoid the responsibilities and obligations of such. ”*

While the bar needs raising, so does the floor. The proficiency level of advice givers needs to be raised to address complex issues like investor longevity, market turbulence, risk management and increasing product complexity. Accordingly, we respectfully suggest that a greater sense of urgency be reflected in the priorities regarding mutual fund fee structures and regulation of the advice component of fee structures .There is a crying need to truly “professionalize” the financial services industry- this should be the OSC vision.

While the OSC intends to publish final proposals for delivery of Fund Facts instead of a mutual fund prospectus, an equally important issue is to deliver key documents BEFORE purchase decisions are made. We believe the mutual fund POS disclosure initiative, which we support, has gone somewhat astray. Kenmar has submitted a constructive critique explaining why the risk measure, advisor risk warning and lack of benchmark information adds to investor risk. We understand that the OSC is reassessing the efficacy of Fund Facts disclosure.

A better descriptor of trailer commissions would be helpful as well. Trailer commissions are paid by the fund manufacturer as compensation for the distribution of mutual funds, and related services. The dealer is being paid to sell the fund, keep records, comply with regulations regarding mutual fund sales, provide account reporting, issue tax documents and pay sales commissions dealer representatives for the sales they book. Obviously, the trailer also includes an element of profit. The amount and nature of investment advice provided is neither defined nor revealed. Fund Facts describes trailers as payment for services and advice. This is misleading. A more truthful disclosure would be that trailer commissions are compensation for distributing the fund. This expense amount should be disclosed in the How much does it Cost? Section of Fund Facts, in the same way that the 12b -1 fees are disclosed in the U.S. in the Fund Summary Document; a discrete line item for high visibility.

**4. Tighten Enforcement:** Investors want to see that justice is done and that white-collar crime is considered a serious form of financial assault. We think a lot of issues would go away with proper enforcement, a point we make with CSA members multiple times per

year. Has anyone ever heard of an enforcement action for NI 81-105 violations? Neither have we.

The OSC initiative is therefore most appropriate and timely. Beyond money, industry wrongdoing affects many aspects of people's lives including stress, marriage and health. The OSC's plan to improve the efficiency and timelines of its enforcement work through targeted case selection, the use of co-ordinated multi-Branch work plans and various strategies to increase early detection of illegal securities-related activity is impressive and welcomed. The Commission certainly applies a lot of intelligent discretion when enforcing policy decisions, perhaps too much, given the amount of wrongdoing and trends.

The penalties contained in settlement agreements often pale in significance to the gains made by those involved in wrongdoing. In fact, many of the fines imposed on individuals are not paid since registrants leave the industry or declare personal bankruptcy. We suggest that fines be increased and disgorgement and punitive damages be added to the tool kit. Moreover, investment dealers should be held accountable for any unpaid fines by individuals – in our opinion, this rule change would result in an immediate change in dealer behaviour and improved supervision.

According to the SRO's somewhere between 80 and 90 % of fines imposed are never collected. This needs to be changed. The OSC/CSA should give the SRO's the legal capability to collect fines. As a backup/alternative, we recommend that dealers be held accountable for payment of all unpaid fines by their employees/representatives. Unpaid fines on such a scale make a mockery of the enforcement system. Further, investors are very interested in **investor restitution** not just fines imposed on registrants. The status quo is just not working – the published SOP does not, but should, address this long standing issue.

Given the slow path towards a fiduciary/Best interests standard, let's at least make the fines and penalties for abuse more punitive. It's hard to imagine anyone would stand up against that who wasn't worried about the fact that they might already be crossing the line. Double the fines if the case involves elder abuse.

The enhanced use of TIP lines, financial incentives for whistleblowers and systematic information sharing via scheduled, formal meetings with the FSCO/IIROC/MFDA/AG / IMET/OBSI et al could also prove effective tools for enhanced enforcement. Reinforcing key strategic alliances with appropriate policing agencies to strengthen and improve investigative tools applied to serious misconduct cases is an important action to re-establish trust in securities regulators and deliver better outcomes. We are delighted to see it among the priorities.

**5. Stabilize OBSI Over** the past two years OBSI has been destabilized. On 4 occasions in the past 6 months, OBSI has been forced to “name and shame” member firms for not accepting its non-binding recommendations. To date, none of these cases have resulted in investor restitution. We can expect more such cases as OBSI has revealed that it has



several stalled cases in its backlog. Clearly, the governing OBSI Framework needs to be updated and the ToR reviewed for adequacy. It appears as if this Framework Agreement has no OSC or CSA ownership. Independent reviews have given OBSI high marks as an independent ombudsman service. OBSI is a public interest entity that merits regulatory oversight especially as it expands its scope to include Scholarship Trusts, Portfolio Managers and EMD's. .

One of our primary concerns is the excessive complaint cycle times that we believe are due to chronic under- resourcing and poor dealer cooperation. CSA oversight would ensure that OBSI was able to function effectively. Investors want an ombudsman that has power and capability to efficiently resolve disputes and flag systemic issues in a timely manner. We therefore recommend that the OSC/CSA provide this oversight and this initiative be reflected in the SOP.

**6. Improve Suitability process/ Complaint handling:** We appreciate that the OSC will continue with its focus on suitability sweeps and take enforcement actions as appropriate. This is necessary and appropriate. We believe that in many cases only real time or near real time software tools that make robust compliance with regulations a reality. Closely related to this is the fairness of dealer complaint handling practices. Unsuitable investment recommendations is one of the top reasons for complaints. Dealer responses too often are unfair, dismissive and abrupt. We recommend that a compliance sweep of dealer complaint handling practices be part of the 2013-2014 work plan. One chronic underlying problem for investors and OBSI (and industry participants) – non-standard, misleading NAAF forms within the industry. If the NAAF/KYC process were re-engineered and standardized, a large number of complaints could be avoided. We recommend this be a specific 2013/2014 priority as it will have a big payoff for all stakeholders. This was recommended to the OSC by the Regulatory Burden Task Force in December 2003.

[http://www.investorvoice.ca/Research/OSC\\_RegulatoryBurden\\_Dec03.pdf](http://www.investorvoice.ca/Research/OSC_RegulatoryBurden_Dec03.pdf)

**7. Engage the Public:** The OSC has made excellent progress in this area. Nevertheless, the OSC's roles and responsibilities still are not understood by the public so continuing effort is justified. The Outreach program seems well suited for this purpose.

To make it more investor- friendly and useful. , more topics on education and streetproofing, investor research and Case studies should be added. The site design should be enhanced to provide better navigatability and search capability for the retail investor including Registrant Check. We'd also like to see advisory designations defined and described so people can better understand the qualifications and training each designation entails.

We'd also like to see more Investor cautionary materials, not just fraud awareness. There are plenty of minefields to navigate with registered representatives/dealers as well.

Documents like the **CFPBoard Consumer Guide to Financial Self Defense**

[http://www.asuupmmc.utah.edu/files/CFPBoard\\_Financial\\_Self-Defense\\_Guide.pdf](http://www.asuupmmc.utah.edu/files/CFPBoard_Financial_Self-Defense_Guide.pdf) ,

and **Consumer Awareness Booklet** ( 28 pages loaded with useful material for the retail

investor)

[http://www.onusconsultinggroup.com/uploaded\\_files/InvestorAwarenessBooklet.pdf](http://www.onusconsultinggroup.com/uploaded_files/InvestorAwarenessBooklet.pdf) are examples of what we'd like to see.

Consideration should be given to reconstituting the OSC Stakeholder Survey <http://www.ontla.on.ca/library/repository/mon/14000/264127.pdf> to provide more polling of retail investors on a broader range of topics. We believe the results would be illuminating and useful in setting action plans and policy.

We are delighted to see that OSC staff will also proactively expand the use of communications strategies to warn investors about potential harm.

We respectfully refer the OSC to *Canada Steps Up*, a comprehensive research report by the *Task Force to Modernize Securities Legislation in Canada* <http://www.tfmsl.ca/> Volume 6 contains an especially relevant paper by Prof. Julia Black, *Involving Consumers in Securities legislation in Canada*.

**8. Deal with complex Investment products.** Structured /hybrid products need to be better regulated and their distribution channels better understood. Amid concerns about the risks posed by complex, structured products to retail investors, global securities regulators are proposing an approach to improving investor protection. The International Organization of Securities Commissions (IOSCO) has recently published a consultation report <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD410.pdf> that analyzes trends in the retail structured product market, and proposes a "regulatory toolkit" for IOSCO members (like the OSC) to use to address the particular risks that these products may pose to retail investors. We believe structured product regulation deserve a spot on the 2013-14 OSC Priority list.

Consideration should be given to bringing Segregated funds under securities regulation as this is a major cause of regulatory arbitrage. A more dramatic move would be to merge FSCO with the OSC to provide better 360 degree knowledge of financial system issues in Ontario but that is a decision for another time...

Our view on crowdfunding is negative for Main Street Ontario investors. The scheme reminds us of LSIF's and Business income trust misadventures. We agree with FAIR Canada that Crowdfunding will amplify Fraud risks.

<http://faircanada.ca/dialogue/crowdfunding-will-amplify-fraud-risks/>

## **SUMMARY and CONCLUSION**

Regulatory bodies exist to safeguard trust in the system. Carping and criticism leveled at a regulator by a regulated industry and its lobbyists are not only to be expected, their absence is cause for concern. This isn't to suggest an autocratic approach, just that the axiom endures: "You can't please all of the people all of the time." Our 2012 Investor Protection Report highlighted numerous breakdowns and missed opportunities to protect



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retail investors. By and large, the proposed priorities do address key investor issues and opportunities. We want however to see more **time-lined solutions** proposed and/or implemented than just statements of concerns and reports .Don't fret if the solutions are imperfect. The investment industry needs guidance, finality and progress more than it needs perfection.

The OSC must distill and clarify the underlying principles so that they become a directional compass for market participants and stakeholders. A complex journey cluttered with many competing players can only be navigated with a clear eye at the helm. Articulate the vision, simplify and hold firm. Faster progress and better outcomes will result.

We note that the OSC plan to operate with a deficit but no explanation is provided. An organization as important as the OSC can't afford to scrimp where staff morale and retention is concerned. Government cost watchdogs and some of the public can be counted on to squawk about fees. But if it takes money to make money, it also takes money to follow the money. It is all well and fine to be concerned about regulatory burden but investor protection is JOB #1 and keeping up with international regulatory developments is essential to making Canada a safe haven for investors.

Kenmar Associates agree to public posting of this Comment Letter.

We would be pleased to discuss our comments and recommendations with you in more detail at your convenience.

Respectfully,

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