



THE INDIVIDUAL FINANCE AND INSURANCE DECISIONS CENTRE
AT THE FIELDS INSTITUTE

May 10, 2003

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I am writing this letter in response to the request by Ms. Nancy Stow (Vice President, Development, Investor e.ducation Fund) to comment on Consultation Paper 81-403 entitled: *Rethinking Point of Sale Disclosure for Segregated Funds and Mutual Funds*.

In terms of background, I am an Associate Professor of Finance at the Schulich School of Business at York University, as well as the Executive Director of The Individual Finance and Insurance Decisions (IFID) Centre at the Fields Institute in Toronto. My research interests and expertise currently reside in the field of personal financial wealth management and insurance.

Please note that the views expressed in this letter represent my personal opinions and do not reflect the position of The IFID Centre or the Schulich School of Business.

Overall, I support the proposal to replace the existing point of sale disclosure documents with minimal fund summary documents and broader foundation documents. My personal experience with individual investors, fund distributors and general financial services professionals confirm the anecdotal suspicion that the large majority of consumers do not read nor appreciate the information contained in the current folder and prospectus.

In response to some of the specific questions listed in the consultation paper, I offer the following comments. I have marked the questions I am addressing at the beginning of each paragraph.

(Q01, pg.12) Do you disagree with our description of the disconnect between theory and practice in this part of the consultation paper? Are there any differences between segregated funds and mutual funds that we should keep in mind as we work to improve their respective disclosure regimes?

I believe that Segregated Funds (IVICs) and Mutual Funds are fundamentally the same financial and economic instrument. They both provide the consumer with a (hopefully) low-cost access to a diversified pool of equities and fixed income instruments that are



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allocated and controlled by professional money managers. As such, their regulation, disclosure requirements and tax-treatment should be identical. If these instruments are treated differently in the eyes of regulators, they open the field up to regulatory arbitrage if and when segregated funds (or mutual funds) are perceived as easier to sell. While I am fully cognizant of the insurance-like maturity guarantee provided by segregated funds, their *raison d'être* is identical to that of the mutual fund. Indeed, the life-insurance risk that is embedded within segregated funds (i.e. the reserves that must be held against the mortality risk) is minimal when compared against a term-life or whole-life insurance policy. At most, one can view the segregated fund as a mutual fund with an additional thin veneer of term-life insurance. The maturity guarantee concept is not unique to the segregated fund market. For example, in November 1998 the CIBC launched a Protected Mutual Fund that promised to return at least the originally invested principal at the end of 5 years. With November 2003 just around the corner, this guarantee might have more value than most of the guarantees embedded within segregated funds with a 10-year money back guarantee. Yet, the CIBC product was legally considered a Mutual Fund and was regulated as such. Other examples of such products also exist.

(Q02, pg. 17) If you are a mutual fund industry participant (either a fund manager or a sales representative), please comment on your experience with the rights of rescission and withdrawal. Have you or your clients ever exercised them? Do they work in practice to give consumers real (as opposed to theoretical) rights? If you are a consumer, please tell us whether you knew you had these rights and whether you have ever used them.

While I personally have never exercised the right of rescission and/or withdrawal when I purchased a mutual fund – nor have I met anyone who has admitted to doing so – this right leaves open the potential for abuse on the part of (sophisticated) consumers who recognize the value of the embedded put option. Some ‘back of the envelope’ calculations – available upon request – indicate that the rational exercise of this rolling put option could be worth an additional 30% to 50% of the value of the initial investment. Hypothetically speaking, an investor with \$100 to invest at the start of the year could grow this sum to between \$130 to \$150 by the end of the year with little risk by selling short-term put options against the natural puts guaranteed within the right of rescission, (assuming these are rolled-over on a weekly basis). While the practical implementation of this strategy would require the cleverness and agility of a hedge fund manager, it is not beyond the realm of possibility for individual consumers coached-on by an increasingly sophisticated financial press. In sum, I believe the right of rescission is an unnecessary and potentially costly way of dealing with the behavioral need for a cool-off period. It certainly makes little sense to impose this option cost on mutual funds, but not on segregated funds. See my comments below in answer to question 12 for an alternative solution.



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(Q03, pg. 25) Our proposals will require operators to post the foundation document and the continuous disclosure documents for each fund they manage on their websites. The IVIC used by an insurance company for its segregated funds will also be available electronically and in paper (on demand). Please comment on the pros and cons of this approach.

I support the idea of posting foundation documents and continuous disclosure documents on their website. If certain consumers are not savvy enough to access this information, but are interested in obtaining this information, they can most likely ask their 10-year-old child or grandchild to help them download the PDF file from the net.

(Q05, pg. 25) We propose that mutual fund managers make the various documents available on their websites, notwithstanding their availability on SEDAR. Are SEDAR postings, alone, sufficient? Is the SEDAR system structured appropriately to fulfill this function? Please comment on the usefulness of SEDAR for accessing individual disclosure documents about a mutual fund.

I have used the SEDAR system on various occasions and very much appreciate the wealth of information available in one central location, however I do not think it is user friendly enough in its current format to be a substitute for making the information available on the fund company or insurance company website. I suspect the additional cost imposed by the apparent duplication would be minimal when one considers the cost of uploading and storing an electronic document.

(Q12, pg. 31) Please comment on cooling-off periods in the context of mutual fund and segregated fund sales. If you believe one should be retained (or introduced in the case of segregated fund sales) please explain why. How should a cooling-off period work given the changes in the market value of funds? How can we prevent market players from using a cooling-off period to play the markets? What would be a correct period for consumers to re-consider their investment?

Given my fears about the potential abuse of the rights of rescission embedded within the current structure of the cooling-off period, as well as the implicit cost born by all investors from the optimal usage of this option, I recommend the following proposal. Note that mutual funds and segregated funds are marketed and structured as long-term investments. They were never designed nor intended to be daily trading instruments. Thus a cooling-off period could then, in theory, be implemented by imposing a 72-hour delay between the time the mutual fund (and segregated fund) units are initially purchased by the consumer, and the time at which the units are considered credited to the account. A first-time fund buyer purchasing units on Monday afternoon would then set in motion a process that would eventually result in a financial transaction at Thursday afternoon's closing NAV. Each and every consumer would be given the ability to override this 72-hour delay -- by clicking on the appropriate box in the form or on the website -- but the default would be for a 72-hour delay. A conscious decision though,



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would have to be made to override this action. First-time buyers will be especially encouraged not to override this delay since they are the ones most likely to experience a change of heart. Thus, if within the 3-day period the consumer cools-off and changes his/her mind they would be able to reverse the decision at zero cost to existing unit holders or the company itself, since the funds would have technically not been invested yet. In the meantime, the funds would be credited to the T-Bill or a money market fund rate. Naturally, this suggestion goes contrary to the recent move towards instantaneous clearing and settlement within the securities industry. I, however, believe it would generate the appropriate balance between the need to protect individual consumers – who might regret their decision after a good night's sleep -- and the need to protect consumers and unit holders as a group against the real cost of granting these put options.

Finally, while I applaud the OSC for taking the initiative on these important issues, I would like to see a greater emphasis placed on educating consumers about the risks in mutual and segregated funds at the point of sale. Thus, while the section on page 37 (which explains the risks of investing), is a good start, I would go further by providing more concise and numerical information about the statistical probability that this particular fund will lose money within a 1, 5 or 10 year period. In this manner, the guarantee element of the segregated fund would be given its due respect and value, while at the same time educating the buyer about the risks.

Thank you for the opportunity to comment on these proposals. Please feel free to contact me directly with any questions at milevsky@yorku.ca or at my office at The IFID Centre: (416) 348-9710 Ext. 3010.

Sincerely,

Moshe A. Milevsky, Ph.D.