Kenmar
Investor education and protection

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Comments on POS Framework Proposal Consultation Paper NI81-406

Kenmar appreciates the opportunity to comment on the Joint Forum proposal National Instrument 81-406. We applaud this sorely needed initiative. While we are disappointed not to see some of the wonderful ideas of the FAIR Dealing Model (FDM), this proposal takes a number of constructive steps towards protecting retail investors . Many issues occur at the point-of-sale that are related to conflicted advice, unscrupulous sales practices and adviser incompetence. This initiative is perhaps the single most important investor protection regulatory proposal for retail investors.

Kenmar is dedicated to investor protection and education. We maintain a website www.canadianfundwatch.com and publish a bi-weekly publication the Fund OBSERVER. Kenmar is actively works with seniors groups, regulators, politicians and the media in trying to represent the interests of Main Street.

Our comments, primarily focused on mutual funds, follow:

POS disclosure is one element, albeit an extremely important one, in the investor protection control system Others include robust fund regulations, registrant qualifications, NAAF/KYC information, Continuous Disclosure documents, fund governance, effective regulatory enforcement, fair dispute resolution, informative Client statements and investor education. As confirmed by the Forum's excellent research , retail mutual fund investors are among the most vulnerable investor groups and thus, regulators have a special duty to safeguard them. It is essential that all elements of the control system properly mesh so that the overall system functions as desired.

Behavioural finance research suggests that most people are far from the rational 'utility maximizers' theory assumes. Instead, they are financially unsophisticated, lacking in knowledge, self-discipline and firm preferences, and easily influenced by outside 'experts'. A 2006 IFIC investor survey asking Canadians why they had invested in mutual funds, found 85 % were, to put this in plain language, persuaded by "someone who provided me with advice and guidance". ***The OSC FDM Concept Proposal concluded that, to a significant degree, adviser compensation rather than the best interests of investors is driving purchase recommendations.*** This has resulted in a $700 billion plus high-fee Canadian mutual fund industry which is dramatically sub-optimizing the assets of the middle class .

A January 2006 U.S. study *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry* that suggests that most mutual fund buyers do not benefit financially from professional advice. The researchers note that while brokerage customers are directed toward funds that are harder to find and evaluate, brokerage customers pay substantially higher fees and buy funds that have lower risk-adjusted returns than directly-placed funds. Comparing weighted average returns, net of all fees except charges paid up front or at the time of redemption, equity funds sold by brokers had an average annual return of 2.9 % between 1996 and 2002. Yet equity funds purchased directly earned 6.63 %, the professors report in one table. Conflicts-of interest are at the root of the problem Source:http://papers.ssrn.com/sol3/papers.cfm?abstract_id=616981

NASD, formerly known as the National Association of Security Dealers, announced June 28th, 2007 that it has settled cases against 3 firms involving mutual fund sales violations. The firms recommended and sold DSC class mutual funds to their clients and did not adequately consider, on a consistent basis, important suitability factors [age, time horizon, type of account, objectives etc.]. This resulted in undue expenses and liquidity constraints .So, are investors indeed getting the shaft?
http://www.nasd.com/PressRoom/NewsReleases/2007NewsReleases/NASDW_019355

A September, 2004 CARP Report, *GIVING SMALL INVESTORS A FAIR CHANCE: Reforming the Mutual Fund Industry*, urged for a number of major reforms including improved Point of Sale disclosure. Another 2006 study led by Harvard Professor Peter Tufano, *Mutual Fund Fees around the World* found Canada to have the highest fees in the world, a strong indicator that all is not well.

Can it be shown that the typical Canadian mutual fund investor is not getting a fair deal from the mutual fund industry? We believe it can. Professor Keith Ambachtsheer did so recently in the article *Losing Ground: Do Canadian Mutual Funds Produce Fair Value For Their Customers?* (with Rob Bauer, Canadian Investment Review, Spring 2007)
http://www.investmentreview.com/archives/2007/spring/CIR_01-2007losingground.pdf
His CONCLUSION: "The preceding financial analyses suggest that the vast majority of the 60% of the Canadian workforce who are not members of occupational pension plans will have a very difficult time generating adequate pensions by investing their retirement savings through the mutual fund sector. This is so despite the very high 20%-of-pay savings rate assumed in the example. The sales/investment expenses wedge being imposed by Canada's for-profit financial services industry is simply too large"

A number of macro-economic and industry trends are also of concern. Through acquisitions, the number of truly independent advisers continues to shrink. Wrap accounts and funds-of-funds are increasingly being promoted with their still higher fee structures. While international mutual funds may make sense for some, they carry higher MER's –interestingly, few advisers recommend low-cost ETF's, Index mutual funds or Fundamental Index funds for this purpose. Life cycle funds with time-varying MER's are also being promoted-these too carry heavy front-end MER's. Corporate pension plans are being converted to defined contribution plans or eliminated altogether. This is increasing the dependence of the average Canadian on mutual funds to provide a comfortable retirement. Group RRSP and Defined Contribution plans are making use of mutual funds as well And, an aging population means that seniors will be increasingly targeted by the financial services industry . The old truism, *Mutual funds are sold not bought*, is as true today as it ever was.

All of this suggests that the Joint Forum's POS disclosure improvement initiative is indeed timely and critical. This goes beyond mere securities regulation-a fundamental and critical social issue is being addressed. The Joint Forum now has a unique opportunity to positively affect the lives and retirement plans of over 10 million Canadians. It will take courage , hard work and determination to do the right thing.

We now present some of out thinking based on extensive experience with investors.

<u>What we like about the NI 81-406 proposals</u>

- basic plain language employed
- pictures, bolding, color are inviting
- font size seems adequate for use by seniors
- Fund Facts (FF) available <u>prior</u> to purchase
- the inability of investors to waive receipt or to accept oral delivery of FF
- much of the key data required is presented
- appears to encourage investor-adviser interaction [there is no delivery sign-off however]
- the lack of access equals delivery provisions
- the warning that certain funds should not be bought for income
- industry Consumer Guide ditched

<u>Concerns</u>: 1. Numeracy / financial literacy <u>may be less</u> than Grade five and 2. Data is <u>not</u> information

<u>Investors *should* want to know</u>

- expected performance of the fund pre-AND after-tax
- the chance of losing money [risk]
- what the ongoing annual cost of the fund is and the long- term effect of annual cost decompounding [context would be provided by annunciation of the impact of fees on long-term returns]
- what they get for the fees paid [portfolio management., admin, regulated Continuous Disclosure reports, client statement and professional Investment Advice]

- how the price of the fund compares to alternatives [other classes /series and other funds, including index funds]
- portfolio fit [the fund's role in the portfolio wrt investor objectives]

Our proposed User Guide can fill in the voids created by the use of the necessarily abbreviated 2-page Fund Facts document. It will add all-important perspective and turn Fund Facts data into information.

Expected performance-key requirements

- identification of the fund [Category, series/class and fund Code identifiers are needed]
- CAGR range for the category over 10 years [clearly identified as pre-tax and assuming reinvestment of all distributions. We recognize that income investors who receive monthly distributions will have to look elsewhere for fund yield]
- comparison with benchmark (s) [NI81 -406 should require benchmarks lined up against performance-this will motivate investors to ask intelligent questions. We regard this as an **essential** data element in Fund Facts (FF)]
- income tax liabilities [classic Moshe Milevsky study on the impact of income taxes on posted returns makes it clear after-tax returns more useful for those with taxable accounts]
- year-over-year variability of returns [the proposed history chart is fine]

Investors would benefit from knowledge of exactly what they are being sold and expected pre-tax returns/risks and after-tax returns.

Chance of losing money indicators

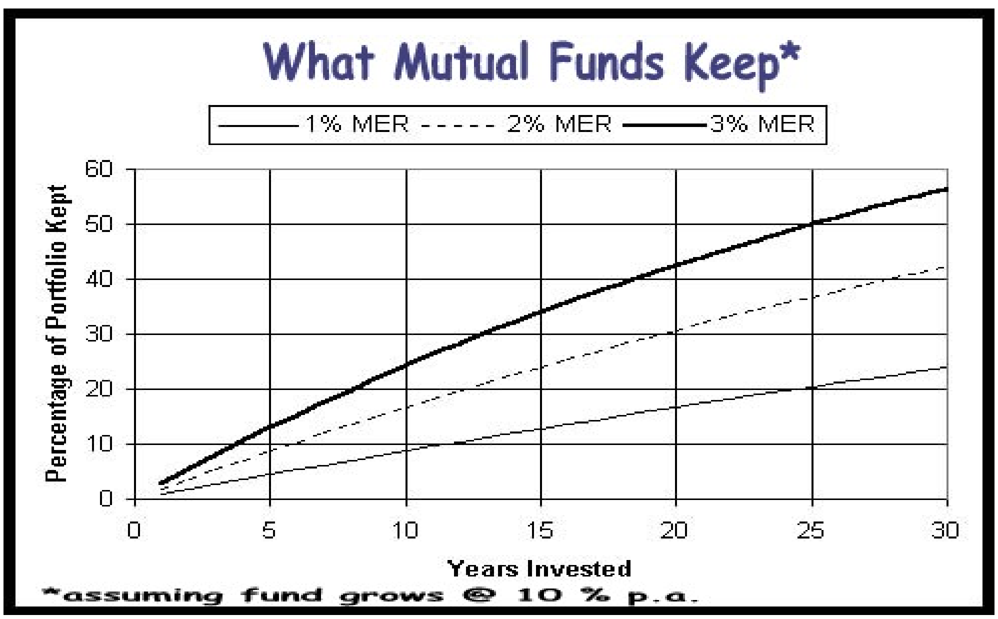
- year-over-year variability of returns [pre-tax return not always a reliable measure outside a tax-deferred account]
- price-to-earnings ratio of fund holdings [for equity funds]
- worst 12-month performance would be a good indicator [by fund or category; we believe investors will relate better to this than the IFIC volatility scale and thus recommend it]
- Beta [plain language equivalent to describe relative market risk]
- maximum Drawdown [a fundlibrary.com metric; also a good risk indicator]

Retail investors do not understand risk concepts in the portfolio context and 81–406 perpetuates the confusion. IFIC "risk" scale is based solely on volatility. We discuss this further later on.

The cost of owning the fund

- MER percent and TER percent for the class/series [TER should be provided where meaningful as it is a very real cost of ownership] The MER presented should be the maximum delineated in the Prospectus. This will unmask any temporary fee waivers and embedded trailer escalators. The adviser can define the actual MER at the point of sale.
- sales commissions to be incurred in % and $'s and cents
- ongoing trailer commissions [this deserves much better explanation as it is at the core of the skewed advice controversy and unduly high fees being incurred by Canadian fund investors. Page 187 of the 2004 OSC FDM Concept Paper stated *".. It appears, for example, that few retail investors really understand what a trailer fee is, or its impact on their long-term investment.."*]
- the long-term de-compounding effect of fees and taxes [this extremely important context is not captured by NI81 –406 initial proposals in our view]

Investors cannot relate the MER and annual trailer commissions to their long-term multi-year adversely impacted returns. NI81-406 should do much more in this area. The generic chart below, if included in the User Guide, tells the message at a glance. It would prompt informed questions which is the purpose of the POS disclosure.



Price comparison

- Fund Category [FF's should disclose per CIFSC standard]
- average MER plus TER for category {TER is a real cost to the investor, not just MER and should be disclosed)

- comparable ETF's [this could be covered in the User Guide]
- other expenses [short-term trading fees, DSC early redemption penalty fees, asset allocation service charges, wrap fees etc. are not mentioned but could be referenced in the Guide]

Investors do not know what they are paying in annual fees in dollars and cents terms. Enhanced client statements would increase investor sensitivity to actual fees, personal performance, tax issues and risks. NI81-406 does not deal with Client statements but they are crucial to get the full payoff of better POS Disclosure. The FDM dealt with this aspect in depth.

Observed Investment Suitability Issues

- KYC/ Investment Policy Statement [regrettably, IPS's rarely used in practice]
- only about 30 % of Canadians have a financial plan
- the role the fund is to play in the portfolio
- excessive fees, expenses, income taxes and interest on unnecessary loans
- liquidity [the DSC is an inhibitor that investors do not comprehend until they try to redeem]
- transferability [proprietary funds have caused many heartaches for unsuspecting investors wishing to change firms]

Unsuitable fund investments are the **Number One** cause of retail investor complaints [2006 OBSI Annual Report] .They are unnecessarily costing Canadians billions of dollars annually. Many of these investor-protecting items cited above should at least be touched on in the User Guide to create awareness. We add parenthetically that IFIC has suggested a POS Disclosure form requiring an investor to sign-off on a purchase prior to making the investment. http://www.ific.ca/pdf/invest/investor-questionseng.asp . A more comprehensive version of such a form can be found at www.investorism.com . NI81-406 has no requirement for proof-of-delivery or investor sign-off of his/her understanding of the fund and applicable terms and conditions. This could become an issue should a dispute arise.

Common Fund investor issues and complaints

- Unsuitable investments/skewed advice
- fund churning and undue account leveraging
- excessive fees [Canada highest in the world, Tufano et al Research study]
- income tax liabilities [can be more important than fees over the long run]
- location - RSP versus open taxable account [per IFIC about 50 % of fund assets are in taxable accounts]

Investors do not know their real personal rate of return or how they are doing towards meeting their retirement / savings objectives. This is a fundamental information gap that better POS disclosure alone cannot resolve. Armed with this powerful information, investors would be more critical and inquisitive. The end result would be increased investor satisfaction and increased financial health. Client statements are the proper location for this information.

Observations and Open Questions

- Legal status of Fund Facts document? [precedence of Docs in event of dispute]
- registration of salespersons aka "advisers"
- Are insurance registrants trained and qualified to sell an investment product such as a Segregated fund?
- U.S. "12b-1" like distribution expense line item disclosure in prospectuses and Annual reports? [this cost breakout would further illuminate a dark area of fund expenses in Fund prospectuses]
- Enforcement is a key success factor of these proposals
- What is FDM status/ Client statements? [Without better client statements investors will not achieve the full benefit of enhanced POS disclosure. Statements close the loop of investor protection]
- regulation of structured products utilizing mutual funds (and hedge funds) such as PPN's? [currently bypassing securities regulations and regulators]
- dispute resolution for Segs? –we suggest that the Joint Forum consider providing OBSI the mandate to resolve disputes involving Seg funds or client accounts involving both Seg and mutual funds . This will harmonize the dispute resolution process for mutual funds and Seg funds and make the process a lot more investor-friendly.

Our Joint forum POS User Guide content suggestions

- How to use Fund Facts
- Why the MER and TER are important /other fund expenses
- what else to consider or query
- the advice- skewing potential of trailer commissions on advisor recommendations
- the adverse impact of fees and taxes on long-term performance
- the concept of an <u>investment **portfolio**</u> and <u>**portfolio risk**</u> [as opposed to single fund risk]
- insurance protection [or lack thereof] for mutual fund investors .Many believe that mutual funds are covered by CDIC especially those bought via a bank branch.
- where to get additional information [the Simplified prospectus, SEDAR, MRFP etc.]
- where to complain if a dispute arises [Dealer, OBSI]

The User Guide can complement the limited 2-page information sheet by making the investor think and educate her (him) self while making a purchase decision. Reference could be made to InvestorEd.ca and its fee-impact calculator, Morningstar.ca (contains after-tax return metrics) and Fundlibrary.com (contains Maximum Drawdown risk metric) .Our proposed User Guide could also include case examples on how to use information to make better decisions and prevent downstream problems and complaints. The idea is to encourage questions.

The Fund Facts form does not make it sufficiently clear that the MER expense deduction from fund assets contains a provision for paying salespersons sales commissions and trailer commissions. As written, there is the false impression created that any “ advice” being provided is “free”. Indeed, it is not all evident that there is even a contractual obligation to provide investment advice, as that term is commonly understood. Prospectuses refer only to providing service, client statements, T- slips and the like. Some firms refer to trailers as service fees, a fuzzy term. Under CRA tax rulings, trailer commissions are in fact sales commissions and not a service subject to GST.

As regards investment risk, the proposed assessment methodology is based on *IFIC Recommendations for fund Volatility Risk Classification.* There are a number of major issues here. First, IFIC is the fund industry's lobbyist so it is not immediately evident that the proposed measure is unbiased and/or appropriate. It has not been subject to serious third-party review and critique. Second, the document is not public but we understand it is based entirely on the standard deviation. As such, it omits governance risk for example. The standard deviation is a measure of volatility which the Joint Form has relabeled as risk in the Fund Facts. A fund could have low volatility but still be an unsuitable investment for the risk averse. Thirdly, since the document is under IFIC control and not public, it could be changed or misapplied without the knowledge or concurrence of investors or regulators. Finally, the risk section omits the fact that mutual funds are not protected by CDI C or any other insurance in the event of insolvency or fraud. Norbourg fund investors have come to learn to their sorrow what lack of insurance coverage and fund governance can mean. Millions of Canadians learned to their surprise and shock that abusive market timing robbed them of over $200 million due to governance breakdown. We recommend a notation on the FF and/or in the Guide.

As the POS Framework does not mandate physical client-salesperson interaction we suggest a page 1 FF Header in bold RED - **IMPORTANT : READ THIS DOCUMENT BEFORE PURCHASE –** AND a Footer –DATE RECEIVED: dd/mm/yyyy. This will help in ensuring delivery and help prevent the FF from getting lost in a maze of marketing materials. The User Guide would suggest retention of the FF.

We have no material comments regarding Cooling- off rights except to note that sophisticated marketing and sales techniques are employed that can hijack the minds of financially illiterate, trusting retail investors. Seniors are especially vulnerable.

We respond to the specific questions posed below:

Questions about subsequent purchases

1. Investors: If you make a subsequent purchase in a fund you own, we recognize you will already have received the Fund Facts. Should we consider waiving the requirement to deliver the Fund Facts for all subsequent purchases of a fund that you own or only for a certain period after the last purchase? If only for a certain period, what is a reasonable amount of time? **Response:** If there are no material changes there should not be a need to overload the investor with redundant information. It is important however that investors continue to have the right each year or on demand to request the prospectus, financial statements and MRFP.
2. Investors: If you are buying a fund under a pre-authorized payment plan, you will only receive the Fund Facts for the first purchase. However, information in the Fund Facts will change over time, which could influence your decision to continue buying the fund. Would you want to receive an updated Fund Facts? If so, how frequently would you want to receive the updated document? **Response:** The MRFP and Annual reports/financial statements should be a good source for updated information providing they too are in plain language. There should be an obligation on the dealer to update investors if there is a material change.
3. Investors: Does the other disclosure information that you can choose to receive, such as fund annual reports, provide you with enough information to make a subsequent purchase decision? **Response:** IF MRFP were improved in quality, they could be a very good source of buy, hold or redeem decisions. The key success factors are competent ethical advisers who understand portfolio construction and have the necessary quantitative skills to tailor the portfolio to the individual investor's needs.

Questions about delivery

We are seeking comments on a number of issues relating to delivery of the Fund Facts because we recognize that the requirement to deliver the document before or at the point of sale represents a significant change to the way that mutual funds, and to some extent segregated funds, are currently sold.

We believe that a flexible approach to delivering the Fund Facts will help address the differing needs and expectations of investors while meeting our goal of providing information at the time most relevant to their investment decision. We are willing to work with industry to help make the transition in as reasonable and cost-effective manner as possible.

4. Do the delivery methods described above give investors and industry enough flexibility to make and execute investment decisions in a timely manner? **Response**: This seems more than adequate although with new technologies the number of methods of delivery is growing all the time. For DIY's, internet access may be adequate.
5. Are there other delivery methods or options that we should consider that are consistent with our objective of providing investors with disclosure before or at the

point-of-sale? **Response:** The key point is that the delivery takes place prior to purchase. We suggest that in the absence of any proof-of-delivery that at least a **Date Received** dd/mm/yy block be a footer on page 2 of FF that would be completed by the investor and retained by him/her.

6. Dealers and insurers: What changes would you need to make to your existing processes to comply with our proposed delivery requirements? How long would it take to make these changes? What costs would be involved? Approximately how much would these costs be? **No comment**

7. Investors: If your adviser did not have the Fund Facts immediately available, would you be willing to wait until you receive it to make your purchase? If you had to wait, would you be likely to choose an investment other than a mutual fund or segregated fund? **Response:** In the Information Age this should be a rare event. The internet, wireless email, powerful laptops, mobile devices, FAX, slim portable printers etc. should make such an eventuality rare.

Question about misrepresentation in Fund Facts for segregated funds

8. Are there other ways to ensure investors have a meaningful remedy for any misrepresentation in the Fund Facts document for segregated funds? **Response:** SRO's could get into the dispute resolution business or OBSI's [or equivalent insurance industry ombudsman] role could be expanded. We would like to see OBSI given the mandate for dealing with Seg fund complaints if they are part of a diversified investment portfolio purchased through an IDA or MFDA member firm.

Question about funds with multiple classes, series or guarantee options

We recognize that there could be many versions of the Fund Facts for a fund that has more than one class, series or guarantee option with a separate MER. We also recognize that an investor may receive only one version of the Fund Facts for the fund, based on their adviser's discretion. As a result, the investor might only be made aware of one option for them to purchase the fund. Advisers should tell investors about all the options that might be suitable.

9. Are there other ways of disclosing the information in the Fund Facts for a fund with multiple classes, series or guarantee options that are consistent with our objective of providing investors with a two-page document that is easy to understand? **Reponse: T**his is a critical point and could dramatically alter long-term portfolio performance. <u>The Fund Code and Fund Class/Series should be revealed in the Fund Facts.</u> [In recommending the purchase of mutual funds, a firm/adviser must assess the suitability of the class of units to be purchased as well as the suitability of the particular fund. Primary considerations include the investment amount, the expected term of the investment, the applicable sales loads, fees and expenses associated with each class, liquidity, the type and purpose of the account and the effect of such factors on the ultimate return on investment to the investor]. The User Guide should mention the general topic of different versions of the fund and encourage investors to ask questions in this area. We add parenthetically that <u>the TER should also be disclosed</u> as it adds to the cost of ownership and is a rough indicator of tax vulnerability. In the case of Bond funds or balanced funds, the portfolio Turnover [measured as average hold period] might be an indicator of tax liability. In any event, some disclosure surrounding income taxes is required Also, <u>performance [not peer] benchmarks should be added</u> –without this fundamental information, the retail investor has no perspective upon which to base an investment decision.

Questions about updating the Fund Facts
The proposed framework allows fund managers and insurers to update the Fund Facts no more frequently than quarterly. Although we want to give industry the ability to disclose reasonably current investment and performance information by allowing quarterly updates, we also want to ensure that investors can easily compare funds. A comparison might be difficult if information in one Fund Facts document is more current than information in another Fund Facts document. **Response:** This is a fact of life; mutual funds are long-term investments so quarterly information should not in general be a major issue. It is important for the investor to understand that portfolio performance is determined more by asset allocation, fees and taxes than by individual fund /security selection. The User Guide could be employed to make this critical point in plain language.
10. Fund managers and insurers: How often would you want to update the Fund Facts? If more or less frequently than quarterly, with what frequency and why? No Comment.
11. Investors: How current do you want the Fund Facts to be? Would a document that contains investment and performance information that is no more than 6 months old meet your information needs? **Response:** Unless there has been a material change, 6 months should be adequate.
Question about misrepresentation in Key Facts
12. Are there other ways to ensure investors have a meaningful remedy for any breach of contract? **Response:** OBSI is the natural route if they are given the mandate. Otherwise the provincial regulator/SRO will have to fill this void. The only other option is expensive and time-consuming civil litigation. or Small Claims Court

One other point: In the For More Information Section of FF there is a reference to a simplified prospectus .At least 3 of our readers thought "simplified" was an adjective, not realizing it's part of the official document name. This is the first mention of this ominous sounding document. You might want to add a little explanatory meat around this key document. Suggestion-The ***simplified prospectus*** *contains much more detail about the fund-ask your adviser for a copy or contact*: [how will the simplified prospectus actually be incorporated in the FF by reference?]

In summary, we have provided a number of areas where Fund Facts can be enhanced without we believe exceeding the 2-page constraint. Benchmarks and trailer commissions top the list. We have recommended that a short User Guide be prepared by Regulators that would illustrate how to use the data to make informed investment decisions. As a collateral benefit, retail investors will be adding to their financial literacy base.

Kenmar firmly believes in capitalism and that the fund industry is entitled to a fair profit for their work. At the same time, we believe the excesses of capitalism which have manifested themselves in this industry need to be curbed by regulatory action. This is a now a national social problem that if not dealt with, will result in a very disappointing retirement for millions, despite years of saving. Ultimately, the reparation cost will fall to Government. Accordingly, we strongly encourage and support the Joint Forum to proceed with this initiative and to be resolute in its timely incorporation into law.

Kenmar
Investor education and protection

We hope that this Commentary will prove useful to the Joint Forum as it considers the optimum ways to protect retail mutual fund and Seg fund investors at the point –of- sale and at points thereafter.

Should you require any additional information, do not hesitate to contact us.

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