Portfolio Analytics
Portfolio Analysis and Restitution services

Neil Mohindra
Acting Policy Manager
Joint Forum Project Office
5160 Yonge St.
Box 85, 17th floor
North York, ON
M2N 6L9
Phone: 416-590-7031
Fax: 416-590-7070
E-mail: jointforum@fsco.gov.on.ca

August 1, 2007

Comments on POS Framework Proposal 81-406

Portfolio Analytics is focused on assessing portfolios for suitability. Often these are after the fact when the investor has lost a considerable amount of money. Our firm assists retail investors in preventing broker or salesperson malfeasance or by assisting investors in obtaining restitution when unsuitable investments have been made. We regularly publish articles in the Canadian MoneySaver and on- line at www.fundlibrary.com/ Most of our attention is directed at mutual funds as that is where the most egregious sales practices appear to be prevalent. Canadians have in excess of $700 billion invested in this security class and depend on the returns for their retirement or other life event(s).

Given the blurring of the wealth management industry between banks and insurers , this harmonization framework is very timely.

POS disclosure is an extremely element in the investor protection control system. Retail mutual fund investors are among the most vulnerable investor groups and thus, this POS disclosure initiative by regulators is welcomed. Many are seniors, retirees or pensioners wholly dependent on their mutual fund or Seg fund assets for their financial well-being. When a senior is sold the wrong fund(s), there is simply not enough time to make up the shortfall caused by unsuitable fund portfolios. Therefore, the POS control point is essential to preventing investor abuse and investor errors. It's a no-brainer for the Fund Facts [FF] to be delivered prior to purchase. But it must be highlighted and not lost in a maze of other sales and marketing materials. As the POS Framework does not mandate physical client-salesperson interaction we strongly 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 actual delivery. This approach has found some value in other consumer products. It's expected that the investor will retain the FF for his/her records.

Fund expenses are among the best predictors of long-term success. With more clarity on costs, we think investors can and will make better choices. The more price-conscious investors there are, the lower fund expenses are likely to be. That's certainly been the experience elsewhere-witness the falling costs in price-competitive industries ranging from computers to airlines. That's why NI81-406 is so powerful.

Financial statements and the MRFP should also break out the amount taken out of fund assets for distribution rather than subsuming it in the " management fee". Taken together with the FF, investors will get a much better picture of the costs of fund ownership and reduce the asymmetric information gap.

As regards Cooperative Marketing Practices – we recommend that mutual funds be barred from utilizing fund assets to pay, to a participating dealer, costs incurred by the participating dealer/sales organization relating to an investor conference or "educational " seminar prepared or presented by the participating dealer. If such payments continue to be allowed by regulators, they should be disclosed on seminar documentation and orally articulated at the time of the presentation.

<u>The FF can be updated if there are changes at 6-month intervals. The latest applicable version should always be available on the firm's website.</u> We also propose a 4-6 page plain language User Guide to 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 <u>data</u> into <u>information.</u> New FF's need not be sent if there has been no material change in the fund [fees or manager].However, we feel the simplified prospectus should be delivered unless the investor specifically requests non-delivery.

We should add that a number of investors inform us that fund salespersons often downplay the importance of the prospectus and annual reports, often using the firm's slick marketing brochures as a substitute. Celebrity shills at "educational " seminars also divert attention and hijack the mind. Accordingly, the Instrument should reinforce the fact that the FF delivery should not be perfunctory act. Salespersons/Advisors should be properly trained and supervised to make the FF delivery important and not degrade its relevance to the investment decision.

What we too often see are a string of abusive sales practices. Adulterated NAAF's, high fee funds preferred over cheaper alternatives, fund churning triggering hefty DSC redemption fees and tax liabilities, high risk (and fee) funds sold to seniors and others, DSC funds in RRIF's, excessive tax vulnerability, non-disclosure of all-in fees, masking of sales commissions and absolutely horrendous client statements. In most cases investors do not know what they are paying in annual fees or even the rate of return they are earning

A few words on DSC- sold funds are in order. While the FF contains a schedule of early redemption penalty fees, the real issues with DSC funds are masked. The issues are well known, albeit not to small retail investors. We encourage the Joint Forum to include in the User Guide some text demonstrating the downside characteristics of a DSC –sold fund. Transaction slips should provide the exact name of the fund, the fund code and the series /class. Many folks apparently don't even know they've purchased Deferred Sales Charge funds until they go to redeem. The abbreviation "DSC" is often not understood.

As an aside, it might not be inappropriate for regulators to lay down a rule regarding the use of fund names- a minimum percentage say of bonds in a fund that describes itself as a Bond fund. Many misleading names exist. The SEC uses 80 % http://www.sec.gov/investor/pubs/inwsmf.htm. Alternatively, the CIFSC Category could be used on the FF. Just putting it on the form could elicit investor questions which is all to the good.

The proposed POS disclosure seem to have turned a blind eye to income taxes. A Feb 2003 research report, *The impact of personal income taxes on returns and rankings of Canadian equity mutual funds* [http://www.ctf.ca/ctjindex/03ctj2.asp # 863] analyzed the 10-year returns of 343 equity and balanced mutual funds managed by Canadian fund companies. The researchers, led by York University Finance professor Moshe Milevsky, assessed the impact of personal income taxes on fund relative performance and rankings. One of the significant conclusions from the research is that performance and ranking of funds on a pretax basis is significantly different from rankings on an after-tax basis. Another conclusion: on average, 1.35% is lost to taxes from annual distributions alone. Before tax, the average annual return for mutual funds with a 10-year history (343 funds) was 9.01% percent. After distributions, the average return dropped to 7.66%. Furthermore, tax is triggered not only by the fund manager's activities, but also when investors dispose of the funds. On average, an investor disposing of a fund stands to lose another 1.0%. according to the report. We therefore argue for after-tax return disclosure.

A September, 2004 CARP Report, *GIVING SMALL INVESTORS A FAIR CHANCE: Reforming the Mutual Fund Industry* [http://www1.carp.ca/display.cfm?cabinetID=343&libraryID=99], urged for a number of major reforms including improved Point of Sale disclosure. The report identified serious problems in the mutual fund industry emphasizing how commissions distort advice. The evidence of conflicted advice driven by commission structures is overwhelming. Investors have squandered precious savings on expensive products, overpaid for worthless guarantees or languished in underperforming funds for too long. Thus , while disclosure alone has important limitations, the greater transparency for investors , the better.

A January, 2006 U.S. study *Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry* 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 [In the U.S. 12b-1 fee might includes a service fee - the highest allowed by law is 0.25 percent]

As to the cooling off period we'd suggest that 5 business days be the standard .It takes time to digest and perhaps discuss with family or colleagues the content of the FF –2 days is simply not long enough. Seg and mutual funds are much more complex products than buying a new Sofa or TV with more severe consequences if the wrong choice is made.

The Canadian investing environment has never been more perilous. 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. Life cycle funds with time-varying MER's are also being promoted-these too carry heavy front-end MER's. New fees are being added and old fees are being masked by reducing the disclosure of the components of the fee-so –called "administration fee". We'd like to see all sales commissions broken out on financial statements as a separate line entry. 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. Canadian demographics means that seniors especially, will be increasingly targeted by the financial services industry .To the extent better information at the point of sale is available, much of the potential grief may be avoided.

Based on extensive experience with investors, primarily those who have experienced the ugly sting of excessive fees, conflicted advice and tax-inefficiency we suggest the following. in disclosures :

- Historical performance of the fund pre-AND after-tax vs. a benchmark
- RISK: the chance of losing money [risk] NOT volatility as proposed via the IFIC risk metric system. We recommend using the *Worst 12 months* statistic.
- what the all-in ongoing annual costs of the fund expressed in % and per $1000 [including the TER] is and the long- term effect of annual feet decompounding [context would be provided by annunciation of the impact of fees on long-term returns]. Most retail investors do not comprehend the eroding effect of continuing fees on long-term returns
- brief delineation of what they get for the fees paid [portfolio management, administration, periodic reports, meaningful client statement and advice] or don't get. We have not seen advice definitively defined in prospectuses.
- how the price of the fund compares to other available classes /series and if there are any price breakpoints
- any automatic conversions to lower cost classes of a fund, say upon cessation of the DSC penalty fee period
- identification of so-called optional fees like transfer fees, asset allocation service fees, wrap fees etc

Enforcement will be a key success factor for the initiative. We note parenthetically that a Calabasas, California -based securities broker was recently accused of taking improper payments from a mutual fund company that he recommended to union retirement plans. http://www.nasd.com/PressRoom/NewsReleases/2007NewsReleases/NASDW_019394 Michael L. Bullock violated securities rules by accepting $262,500 in payments in 2002-03 from fund giant Massachusetts Financial Services Co, a Boston-based Sun Life subsidiary, and then deceiving clients about taking the money, according to the NASD. [the U.S. counterpart to the IDA]. The case marks the first time the NASD has singled out an individual broker for receiving money from a fund company under a so-called directed brokerage arrangement. Previous cases have targeted brokerage firms for the fee-sharing arrangements, which entailed payments from fund companies to the brokerages that sold their funds. In Canada, we're not sure if there is in fact anything to enforce since there is no need to show proof of delivery or joint sign-off of an agreement to purchase. We do know that trailers are paid to Canadian discount brokers even though they do not and cannot provide advice without regulatory comment or action. Although we have not been able to locate the provision(s), we assume there are specific rules prohibiting the use of directed brokerage in Canada.

We recommend that there should be some mention made of dispute resolution processes. OBSI have reported that a high percentage of investors are often not aware of their no-charge services because dealers have not told them. This would be in the User Guide.

We must add our dismay that the Joint Forum has chosen not to post submissions to its website as received. This almost guarantees that submissions by individual investors and investor protection groups will be lost when the mass posting takes place on Oct. 16. It also cuts off individual investors from seeing what others like themselves are proposing and throwing in their ideas before the expiry deadline. We urge the Joint Forum to reverse this anti-investor policy and post submissions as received. It is ironic that an initiative designed to improve communications is taking this unjustified approach. We recommend a review of Julia Black's insightful study *Involving Consumers in Securities Regulation*
http://www.lse.ac.uk/collections/law/staff/black/Involving%20Consumers%20in%20Securities%20Regulation%20-%20Taskforce%20report.pdf.

The POS initiative needs to be complemented by post -purchase information. This will help close the information gap loop. If client statements contained a delineation of costs, just as consumers find on all their other bills, this will help them better appreciate what they are paying in sales commissions in dollars and cents, some of which may come to them in the form of advice [it's not often clear to investors whether commission payments necessarily lead to a contractual obligation to provide investment advice]. The fund industry will likely crow about the costs of providing customized statements about ownership costs, but we'd argue that most unitholders would be willing to pay modest additional costs if it means they'll know better what they're paying. And if more fee transparency ends up bringing down expenses across the industry, it might possibly offset any additional expenses.

Coupled with investors receiving their personal rate(s) of return, the information gap will be narrowed and abuse/disputes will be curtailed. We note that IFIC has adopted the Modified –Dietz formulation as a voluntary standard, subject to certain provisos. The trouble is, so few fund investors ever get to see in black and white what they are actually earning.

In summary, we fully endorse the initiative but would like the initiative to better focus on the long-term impact of fees and to highlight the possible conflicts- of- interest due to embedded sales commissions and especially ongoing trailer commissions. The application of a benchmark to returns is essential so investors can better conceptualize the impact of fees and the contribution of professional active management Group RSP plans should be included in the harmonized regulations. We have recommended that a short User Guide be prepared by Regulators that would illustrate how to use the FF data to assist small investors in their mutual fund investment decisions. The POS initiative must be part of an integrated approach to disclosure to protect investors, including in particular post-sale fee and return information. We expect that NI81-105 will need to be amended to reflect the obligations now in this proposed Instrument.

This initiative is critical and long overdue. Retail investors are losing billions annually due strictly to the asymmetric information between them and those selling them mutual funds. The losses are such that retirement and savings plans are being seriously compromised. Ultimately, the reparation cost will fall to Government and all taxpayers to rectify. Accordingly, we strongly encourage and support the Joint Forum to proceed with this initiative without undue delay.

We greatly appreciate the opportunity to have provided an input and sincerely hope the future will be better for mutual and Seg fund investors.

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

Sincerely,

Ken Kivenko P.Eng.
President, Portfolio Analytics
(416)-244-5803
kenkiv@sympatico.ca