

Kenmar Associates

Dedicated to Investor Protection

Sent via email

Robert Day
Senior Specialist, Business Planning and Performance Reporting
Ontario Securities Commission
20 Queen Street West
Suite 1900, Box 55
Toronto, Ontario M5H 3S8

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(416) 593-8179
rday@osc.gov.on.ca

ONTARIO SECURITIES COMMISSION NOTICE 11-769 – STATEMENT OF PRIORITIES

REQUEST FOR COMMENTS REGARDING THE STATEMENT OF PRIORITIES FOR FINANCIAL YEAR TO END MARCH 31, 2015

http://www.osc.gov.on.ca/en/SecuritiesLaw_sn_20140403_11-769_rfc-sop-fiscal-2014-2015.htm

Kenmar Associates welcomes the opportunity to comment on the Proposed Statement of Priorities (SOP). Retail investors might lose money through not understanding the products' complexity. Several events, including the 2008 default on products relating to the Lehman Brothers failure, exposed the problems retail investors can face with structured products.

Kenmar is an Ontario-based privately-funded organization focused on investment fund investor education via on-line research papers hosted at 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. The Office of the Investor is unique among Canadian regulators. The financial support for FAIR Canada has been a very positive action since the Canadian investor advocacy community is chronically underfunded. The OSC's process for consultation from stakeholders is more than fair and has greatly improved in quality and participation these last three years.

With the evolution of the investment markets, a multitude of complex 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, investor overconfidence in their investing skills, undue trust in advice givers 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 has, to a large extent, the appropriate priorities and emphasis 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, the SRO's and others. The frequency, grandeur and sophistication of “Free lunch” seminars is a real concern.

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, gender equality on Boards etc. Here are our recommendations regarding retail investor protection priorities for the year ahead:

1. Establish a Seniors Advisory Committee to laser focus on senior’s issues: A recent IIAC report made it clear that 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 “senior crisis” posed by the risk of seniors' outliving their assets and their declining ability to manage their money as they age must be addressed. 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 RRIF's, time is of the essence. This is a major socio-economic issue as well as an important regulatory issue. We recommend that the OSC establish a Seniors Advisory Committee to keep on top of the developing situation. This would be very cost-effective.

2. Decide on Best interests standard for all advisors: The Draft SOP states “(a) *Complete the joint OSC/IROC/MFDA mystery shop research sweep of advisers to gauge the suitability of advice currently being provided to investors and (b) Complete research that will inform our decision regarding the application of a best interest duty and evaluate options to move forward”* ..Much independent research has already been done in Canada and elsewhere that demonstrates that conflicted advice acts against investors. Our comment letters on Fund Fees and Best interests provided a comprehensive listing. Roundtables have been held. OSC Enforcement and Compliance reports have been issued that year after year contain the same issues. (merely issuing reports and suggested practices leads only to a quick read and discard by firms and a repeat of breaches the following year)

Multiple consultations have been conducted. CBC's Market Place mystery shopping experiences shows that the advice industry is not up to the job. An analysis of complaint data also shows the fundamental weaknesses of the suitability regime. It has been a decade since the FDM was first proposed. We respectfully suggest that the impact on

Ontarians of NOT imposing a best interest duty is fairly obvious. 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 consideration of the broker and investment dealer business model. Time is of the essence.

It is glaringly evident to us that investment advice robustness needs to be dramatically improved. 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. Professional financial advisor and author John DeGoey has enumerated the advantages of prohibition are numerous and include:

- Transparency- investors will understand very well that neither mutual funds, nor advice associated therewith is “free”.
- 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).
- Exploding the myth that both mutual funds and the advice associated with them is “free”
- Allowing for potential [tax] deductibility depending on the nature of the account
- Removing the potential of compensation-induced bias- both within and throughout product lines
- Enhancing consumer confidence in both advisor motives and the actual advice given
- Improving consumer understanding of the constituent component parts of mutual fund costs
- 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 the pace of reform has been slow for an industry entrusted with the retirement 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

A [2013 Rotman School of Management study](#) by Dr. Susan Christoffersen of the Rotman School of Management found that mutual funds offering higher fees attract the most investments, particularly when the broker isn’t directly affiliated with the mutual fund. This is a common problem in the investment area. The old idiom: “You get what you pay for.” holds true in many cases but as this study suggests, not for mutual fund investments. The study analyzed how the broker fees correlate into managed assets. This study uniquely correlated fees with the amount of assets under management. For each additional dollar that the broker makes, another six dollars comes under management. The amount of money under management per dollar of compensation to the broker spikes

to \$14 if the broker is an unaffiliated third party who works off of commissions. Clearly, conflicts-of-interest drive commissioned salesperson behaviour.

On October 14, 2013, FINRA issued a [Report on Conflicts of Interest](#). The report summarizes FINRA's observations following an initiative, launched in July 2012, to review conflict management policies and procedures at a number of broker-dealer firms. The report focuses on approaches to identifying and managing conflicts of interest in three broad areas: enterprise-level conflicts governance frameworks; new product conflicts reviews; and compensation practices. The sheer number and nature of conflicts-of-interest is breathtaking as is the potential harm to investors.

3 Get a handle on misleading Titles 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. An unusual number of titles are aimed at misleading the elderly. We'd like to see the OSC rein in these misleading monikers by the use of meaningful sanctions and fines.

4. Resolve Mutual fund industry issues A significant proportion of retirement savings has been, and continues to be channeled into the mutual fund sector in Canada. Over a trillion dollars is invested in mutual funds by 12 million Canadians. Because of embedded commissions and other factors, Morningstar gave Canada's fund industry an F grade (the lowest rating) in a 2013 global ranking for having the highest fees among all the 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. 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 faster action with a sense of urgency

5. Advisor proficiency 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. There is a crying need to truly "professionalize" the financial advisory industry- Best interests should be the OSC vision. As noted, the Ontario Government is currently examining the need for more consistent standards for individuals who offer financial advice and planning services. We are pleased to hear that the OSC will work with the government as this important initiative evolves. We recommend also that the OSC keep a careful watch on Bill 57 , a private members Bill that does not include a fiduciary duty for advisors.

6. Delivery of Fund Facts before sale. We support this CSA/OSC initiative and have provided extensive comments in our formal Submission.

7 Regulation of Fixed Income Securities We strongly support this as a priority issue. As noted, the fixed income market has substantially increased in size in the last decade and there is a large presence of retail investors, particularly seniors/retirees, invested in this market directly and indirectly. As people age, the proportion of the portfolio in fixed income increases so this will be an increasingly important issue over the next few years. As noted by the OSC, corporate bond trading is opaque with limited post-trade transparency for both regulators and retail investors. This lack of transparency limits the OSC's ability to determine whether retail investors and small institutional investors are obtaining best execution. We encourage the OSC to better understand the significant issues affecting fixed income securities and those who invest in them, and to act on identified opportunities where changes to regulatory approaches would improve price transparency and better protect investor interests.

8. 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 effective enforcement, a point we make with CSA members multiple times per year. Has anyone ever heard of an enforcement action for NI 81-105 Mutual Fund Sales Practices 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, effectiveness and timelines of its enforcement work is welcomed. 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 improvement in dealer behaviour and improved supervision.

According to the SRO's, somewhere between 80 and 90 % of fines imposed on individuals are never collected. Unpaid fines on such a scale make a mockery of the enforcement system and the deterrence value of fines. This needs to be changed. We urge the OSC/CSA to 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. 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.

9. Stabilize OBSI One of our primary concerns is the excessive complaint cycle times that we believe are due to chronic under- resourcing and poor dealer cooperation. The

OBSI caseload will increase as EMD's and PM's are added to the list of participating firms. Oversight will hopefully ensure that OBSI is 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 believe that there are still some open issues with regard to OBSI. Specifically, we believe that there should be a regulatory investigation of each and every case where an OBSI recommendation is not accepted by a dealer. The findings should be published and compensation, as appropriate, provided. Secondly, we believe that regulators owe investors an explanation of what will happen, if anything, when they are advised by OBSI of a systemic issue. Finally, we remain concerned that OBSI is unable to investigate an investment portfolio that contains a Segregated fund or other insurance products.

9. Improve Suitability assessment 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 dealer 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 2014-2015 work plan.

One chronic underlying problem for investors and OBSI (and industry participants) – non-standard, misleading and inadequate 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 2014-/2015 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

10. Engage the Public: The OSC has made excellent progress in this area. The Outreach program seems to be working well. To make it more investor- friendly and useful, more topics on Baystreetproofing, investor research and Case studies should be added. The website design should be enhanced to provide better navigability.

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 ,

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

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 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 Professor Julia Black, *Involving Consumers in Securities legislation in Canada*.

11. Deal with complex Investment products. Structured /hybrid products need to be better regulated and their distribution channels better understood. Retail investors (and even their advisors) might lose money through not understanding the products' complexity. Several events, including the 2008 default on products relating to the Lehman Brothers failure, exposed the problems retail investors can face with structured products. The International Organization of Securities Commissions (IOSCO) has published a final report [Regulation of Retail Structured Products](#), 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 2014-15 OSC Priority list given the risks involved and the growth curve of these complicated products.

12 Walk away from Equity Crowdfunding

We do not see this as a priority. In fact, our view on equity crowdfunding is negative for Main Street Ontario investors. The scheme reminds us of LSIF's, Business income trust and non-bank ABCP misadventures. We believe Crowdfunding will also amplify Fraud risks. Our Comment letter on this issue provides more details. It is inevitable that crowdfunding will lead to public scandals and well publicized horror stories. This constitutes a major risk for small investors but the OSC too will suffer immeasurable reputational risk for allowing an exemption rejected by all Advocacy and Consumer groups.

13 Shareholder Democracy

We agree with this priority. The ability to vote on certain key decisions is a fundamental shareholder right. Shareholder voting plays an important role in the fairness and efficiency of our capital markets. On a number of occasions we have raised concerns about the reliability and accuracy of the proxy voting infrastructure that records shareholder votes. We believe it is critical that the proxy voting infrastructure records votes accurately and reliably, and it is necessary for market confidence that it is perceived to be fair. One area we have highlighted in the past is the shares associated with securities lending.

As an aside, it is our considered opinion that shareholders should have the right to nominate/elect Directors and are therefore are not supportive of the OSC plan to make gender equality on Boards a regulatory issue. Shareholders should be free to nominate

/elect anyone to the Board without restriction as to gender, colour or ethnicity, focusing on qualifications and experience. Besides, for smaller TSX listed companies this adds an unnecessary constraint and a regulatory burden via increased disclosure obligations.

14. Withdrawal and Rescission Rights

Withdrawal and rescission rights are not uniform across Canada, are not understood by retail mutual fund investors and are therefore rarely used. A quick scan of differing requirements between provinces explains why these “rights” are of no practical value to the average mutual fund investor.

[http://www.ipcc.ca/files/Compliance/IPCIC_Policies_Procedures_Manual/D2-Mutual Fund Legal Rights and Obligations 17.pdf](http://www.ipcc.ca/files/Compliance/IPCIC_Policies_Procedures_Manual/D2-Mutual_Fund_Legal_Rights_and_Obligations_17.pdf)

Two business days can hardly be called a “Cooling Off” period. Cancellation rights in consumer protection legislation generally allow a consumer to cancel a contract within a specific period of time at no cost to the consumer – the consumer is put back into his/her pre-contract position. For example, Under the *Consumer Protection Act* (Ontario), a consumer may, without any reason, cancel a direct agreement within 10 days of receiving the written copy of the agreement. Under the *Condominium Act* (Ontario)¹, a developer must refund, without penalty or charge, all money received from a purchaser under an agreement of sale, together with interest on the money calculated at a prescribed rate, if a notice of rescission is received within 10 days of the agreement. This is yet one more reason investment dealers should provide Fund Facts prior to or at the time of sale.

We see no evidence that the OSC is proposing amendments to withdrawal or rescission rights applicable to mutual fund transactions. Numerous submissions we have made over the years have underscored the need for additional clarity on their interpretation and application as well as rationalization and harmonization of these provisions. The pre-sale disclosure proposals for mutual funds bring the need to respond to these submissions into sharper focus.

15 Regulatory Arbitrage Wealth Management is a declared strategic goal of the three main pillars of the financial services industry – banking, insurance and investments. It is clear that arbitrage is growing as all pillars are competing for the same demographic. Regulatory arbitrage often leads to a race to the bottom as has already happened with banking Ombuds complaint handling. Such arbitrage contributes to unfair and disorderly financial markets. Retail investors are always the big losers in these arbitrage situations. At a minimum, consideration should be given to bringing Segregated funds under securities regulation as this is a major cause of regulatory arbitrage. One suggestion that keeps coming up would be to merge FSCO with the OSC to provide better 360 degree knowledge of financial system issues in Ontario.

SUMMARY and CONCLUSION

The OECD warns poverty among seniors is rising in Canada providing yet one more good reason to constrain mutual fund fees, introduce a Best interests standard and ensure systemic issue complaints are promptly investigated.

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<http://www.theglobeandmail.com/report-on-business/top-business-stories/oecd-warns-poverty-among-seniors-rising-in-canada-points-to-public-pensions-gap/article15600342/>
Report at <http://www.oecd.org/canada/OECD-PensionsAtAGlance-2013-Highlights-Canada.pdf>

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. But tough decisions need to be made. This isn't to suggest an autocratic approach, just that the axiom "You can't please all of the people all of the time." endures: Our quarterly Investor Protection Reports highlight numerous breakdowns and missed opportunities to protect retail investors.

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. An organization as important as the OSC can't afford to scrimp where staff morale and retention is concerned. Industry cost watchdogs 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,

Ken Kivenko P.Eng.
President, Kenmar Associates
kenkiv@sympatico.ca