

**Presentation to
Ontario
Standing Committee
on
Finance and
Economic Affairs
By**

**Consumers
Council of
Canada**

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presented by
Whipple Steinkrauss
Vice-President

Michael Lio
Executive Director

EXECUTIVE SUMMARY

A number of recent studies reveal a shockingly low level of financial literacy in Canada despite efforts by the financial services industry to educate the small investor. Many Canadians find the industry very difficult to understand. At the same time, the low interest rate environment, the gradual disappearance of defined benefit and other relatively secure pension plans, and the growth in heavily marketed investment products such as trusts and mutual funds, have all contributed to a marked increase in the number of Canadians participating in the securities marketplace. It is clear that the regulatory framework and governance of the industry must be redesigned to take this reality into account.

The Consumers Council of Canada (CCC) recommends that the following changes to the governance and regulation of the industry be implemented immediately:

- 1. The introduction of whistle-blower protection in the industry to protect those who expose wrongdoing and illegalities and the requirement that they do so or face the prospect of being held liable for aiding and abetting that wrongdoing where there is evidence that they were aware of it. Legislation should be developed requiring the industry to report all illegal activity to the appropriate law enforcement authorities and encourage the laying of charges where appropriate.*
- 2. The responsibility for consumer protection be completely removed from the industry and given to an independent consumer protection authority funded from the fees paid by industry registrants and staffed by non-industry individuals who have backgrounds in such fields as investigation, consumer protection, and securities law.*
- 3. Develop a standardized Know Your Client (KYC) form for the industry clearly defining all terms used,*
- 4. to be signed by both the individual investor and the industry representative with a copy to be retained by both parties. This form should also indicate how to contact the consumer protection authority should the investor be the victim of malfeasance or negligence. The process for informing new investors should include a set of minimum requirements*
- 5. The consumer protection authority should be tasked with the development of standardized, up-to-date plain language documents to assist the investor in assessing the products in the marketplace and establishing requirements for their distribution.*
- 6. Where a settlement is reached between the industry and an individual investor in the case of wrongdoing or negligence, the use of confidentiality clauses should be prohibited by law so that consumers can inform themselves of the history of investment advisors.*
- 7. A new redress system for the small investor should be put in place that is funded by the industry, that can be accessed at minimal cost, provides expertise to assist the small investor if required, and guarantees timely resolution and recompense. Decisions should be made by an unbiased panel made up of an equal number of industry and consumer representatives and a neutral chairperson*
- 8. A fixed portion of industry fees should be dedicated to consumer education to ensure that this issue is adequately addressed. The program should be delivered by the independent consumer authority.*

ABOUT THE CONSUMERS COUNCIL OF CANADA

The Consumers Council of Canada is an independent, not-for-profit organization, federally incorporated in 1994 to give a voice to consumers and to help business and government manage today's consumer issues. The Council is arguably the most active, multi-issue consumer group in Canada. Our goal is to work collaboratively with consumers, business and government to solve marketplace problems. The Council's independent research has come to be valued by business and government alike.

Our members, both individual and corporate, acknowledge and support the eight international consumer rights to basic safety, information, choice, representation, redress, consumer education and a healthy environment in addition to supporting the consumer's right to privacy. Our corporate members demonstrate their commitment to corporate social responsibility, accountability to their customers and connection to the community by aligning their organization to our "citizen brand". The Council believes it is good business to manage consumer issues effectively. We encourage organizations to look to the Council as a partner in addressing consumer issues. We have brought along a package today which provides more details about who we are and what we do.

Today we wish to address a number of issues relating to overall governance, information and disclosure, representation, redress and consumer education.

WHY WE ARE HERE

Studies by the Financial Consumer Agency of Canada, consumer organizations in Quebec, the Cartier Group and the Consumers Council of Canada all indicate a shockingly low level of financial literacy in Canada despite the fact that virtually all Canadians have contact with the financial sector and increasingly with the securities industry. Not surprisingly, given their complexities, the insurance and securities industries are the least well understood. Surveys indicate that financial institutions are the primary source of information about savings and investment vehicles. One third of those studied find the information provided to them difficult to understand. The most satisfied with the current system are reasonably well-educated men between the ages of 45 and 60. Those most in need of assistance are the young, the less well educated and women, especially those over 65. We present this information against the backdrop of a changing environment.

WHAT HAS CHANGED

1. The low interest rates of the last decade are driving small investors, especially seniors relying on capital returns for much of their livelihood, into higher risk investment vehicles such as equities in order to survive.
2. The decline in defined benefit pension plans has brought many new players, especially the young, into the financial markets as overseers or direct managers of their pension investments.
3. The sales culture of the investment industry has become increasingly aggressive because of compensation practices in the industry which reward sales volume rather than return on investments for their clients.
4. There are a host of new, relatively complex, investment vehicles being aggressively marketed to small retail investors who have neither the experience nor skills to understand them and hence are unable to assess their appropriateness for their portfolios.

5. Unsophisticated investors have come to rely on the "professionalism" of industry participants as they would their physicians to look out for their financial health often through wrap accounts or simply by trusting in the advice they are given because they lack the knowledge and skills to evaluate the advice.
6. Contracts covering arrangements such as wrap accounts are designed to make the industry as bullet-proof as possible regardless of the performance or ethical conduct of the industry representative serving the client.

While the majority of people in this industry are decent, hardworking individuals who strive to produce the best possible results for their clients, there are those in the industry who profiteer at the expense of the guileless and the uninformed. It is the Council's view that the current regulatory regime is failing this group. **The Council's primary concern is the protection of the small investor, recognizing many of whom are not investors by choice.**

OVERALL GOVERNANCE

To paraphrase Eliot Spitzer, there is little incentive for self-regulatory organizations to monitor quality and expose fraud as such exposure often is interpreted by the public as a sign of failure in their organizations. As a result, honest players who blow the whistle usually end up unemployed or at minimum side-lined. Recently, we have seen countless examples of all-powerful organizations abusing their authority and the public trust when not adequately monitored. The Council supports the proposition that in all corporations, be they public or private, whistle blower protection should be afforded to those who expose illegality and wrongdoing. Indeed we would go further and make it mandatory for those with knowledge of any illegality to expose it or be held liable for aiding and abetting it. The securities industry should be no exception. Given the impact this industry can have on the lives of individuals, such legislation is of vital importance. Further, we would argue that it should be mandatory to report all illegal activity to law enforcement agencies and where appropriate charges be laid. Simply expelling bad actors from the industry does little to build confidence in the industry and nothing to compensate the hapless victim. These types of measures serve to redress the imbalance of power between the corporation and the individual.

There are interesting examples of the pursuit of self-interest in this industry. For example, the IDA has long been seeking the statutory immunity enjoyed by governments despite the fact it has no legal mandate to act in the public interest or to protect the consumer. Indeed in the Morgis case, the courts found that the IDA has no duty of care to the individual investor. Further while it can impose fines on its members and expel those who do not pay them, it has no authority to collect from those who leave the industry. In cases such as that of Mark Valentine of Thompson Kernaghan, the investors were left to pursue him in court at their own expense. The existing arbitration process is expensive primarily because it is based on a court model where most investors need to engage relatively sophisticated counsel to present their case. Many small investors simply cannot afford the process. Add to this limits on compensation, the time it takes to get to a remedy, and the forfeiture of the right to sue and one can understand how consumers conclude they are poorly served by the current system..

Other jurisdictions have recognised the limitations of SROs and, in the case of Britain, done away with them entirely on the grounds that they represent the interests of their members over those of the investing public. Others have given outside bodies the authority to undertake operational reviews of them.

While the Council does not purport to be an expert on which might be the best model of governance to achieve the dual role of investor protection and fostering fair and efficient capital markets, it suggests that the conflicts of interest in the existing system are unacceptable. **There is clearly a critical need to improve investor protection by rebalancing the interests of the investor and the industry. The consumer protection role should be completely removed from industry control.** Part of the fees paid by registrants should be allocated to an independent consumer protection authority that has no other role.

INFORMATION/DISCLOSURE

It is very difficult for a small investor to get the information needed to make a wise purchasing decision. Often the only information given is verbal and limited to facts that help to sell the product. For example, rarely are individuals made aware of the higher levels of compensation for selling rear-end load funds rather than front-end or no loads. They are simply told there is no charge for this transaction. This makes them very attractive to those with the fewest resources such as the very young and the vulnerable elderly. Most investors have no idea exactly how and how much the salesperson earns for different types of transactions unlike the information available to those purchasing real estate.

Know Your Client forms (KYCs) are a key component in the effort to assess consumers and provide appropriate information. Yet, these are used to only encourage the purchase of appropriate investments. The forms are not standardized. The terms used are not defined (eg. what is a conservative or sophisticated investor?). Many do not require the signature of the investor. The investor often is not given a copy. And finally, there is no requirement that they be reviewed at regular intervals.

So what happens on the ground. We have been told about aging seniors with up to 80% of their portfolios in high risk equities such as technology stocks, other seniors within a year or two of their RRSP rollover, who have had most of their portfolios converted to rear-end load equity funds or others with wrap accounts where a third of the portfolio has been eaten up in churning transactions. In case#1, the investor was called by the broker and told he could dramatically increase their modest income. In other words, these investments were solicited. In case #2, the individual was told these funds would offer the best return and there would be no brokerage charges so the senior agreed, again solicited transactions. In case #3, the customer had literally signed away any right to redress in the wrap account agreement. Where these types of cases have been pursued, the courts rarely find in favour of the investor because the investor has agreed to the transaction. These are not individuals looking to make a fast buck on the darling stock of the moment but trusting souls who rely on their "financial advisor" to look out for their interests. Regardless of what percentage of the transactions in the industry are as unethical as these, they are unacceptable and the Council believes their number will increase if the current regulatory framework of the industry is not changed as more and more Canadians lacking financial literacy enter the securities market.

Often when written information is provided eg. When one opens an account, the amount can be overwhelming to the average investor and the language used often not fully understood. A separate consumer protection authority could mandate standardized, plain language documents and the process to be used when informing new investors.

Another major concern of the Council is the practice of putting confidentiality clauses in settlements between the industry and an individual investor who has been the victim of some type of negligence or malfeasance and, indeed in some cases, criminality. As a result, a prudent investor seeking out a reliable broker or advisor has no way of knowing about the history of very bad actors unless they have been criminally charged and convicted. The culture of the industry is to keep such matters quiet so as not to undermine confidence in the industry. From the Council's perspective, the only cases that seem to be referred to law enforcement authorities are those in which the industry has suffered a major loss or the press has learned of them and created a public issue. Industry participants who are known by some to have been guilty of some very significant improprieties up to and including criminality often find their way back into the industry because they have a good sales record. The Council recommends that the law require the industry to report all illegal activity to the law enforcement community and charges be laid where appropriate. A public record of convictions must be reasonably accessible by consumers as they decide where to do business.

REDRESS

Arbitration between parties with widely different levels of resources at their disposal is not a suitable mechanism for resolving disputed. In the case of the securities industry, it has very significant resources to defend itself. The most significant cost to the individual is the cost of legal services in what can be and often is a long drawn out, court-like procedure. For many small investors, arbitration is not affordable. For others with more resources, it is questionable whether a cost of up to \$15,000 is reasonable when the cap on compensation is \$100,000, the decision is binding and precludes any further legal action. An appropriate redress mechanism for the small investor should be characterized by:

1. Minimal if any cost, with frivolous claims prescreened.
2. An industry code of conduct developed by industry and consumers.
3. The availability of expertise to assist the investor to address the imbalance of power and resources.
4. Timelines around resolution.
5. An unbiased panel to rule on the matter with equal consumer and industry representation and an independent chair.

The Council is aware of investors who have won significant settlements in court that were drawn out over 10 years. For most seniors, such a process would either destroy them emotionally and financially or come too late for them to even know about the result.

CONSUMER EDUCATION

As we indicated at the outset, the level of financial literacy among Canadians is shockingly low. Since neither our elementary or secondary school systems have ever had this as a responsibility, most adults are absolute beginners especially with respect to investing. One of the most striking findings for the Council in its study alluded to earlier was that many overrate their level of literacy, that is they do not know what they do not know. Hence they don't get answers because they don't know the questions. This adds significantly to their vulnerability. The Council believes this is a serious problem and one which governments even in their own self-interest must address immediately. If significant numbers of financially illiterate citizens are left to navigate the complex financial services industry without help, many will undoubtedly reach their retirement years with little if any income because of unwise decisions made with their pension assets. The same fate may befall some of our less well-educated seniors. A consumer education program is needed appropriately as part of the function of an industry-independent redress authority. Industry's fees should resource financial consumer education. The authority should produce up-to-date, plain language materials available on an as needed basis in a variety of formats (paper, on-line). A telephone hotline service for those seeking independent advice should also be available. This would not include recommendations re specific products but information on how to assess them.

We trust our perspective will be helpful in your decision-making and thank you for your attention