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Presentation

to the

Standing Committee on Finance and Economic Affairs

for Ontario.

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THEME:

THE INDUSTRY IS SERVING ITSELF …WHO IS SERVING THE CANADIAN INVESTOR???

ARE INVESTMENT CLIENTS IN A "BUYER BEWARE" RELATIONSHIP?

Some investment dealers say yes.

When the average Canadian decides to deal with a high-quality investment firm in response to its advertising, do they think they are dealing with an advisor who will act in their best interests and be held to professional standards, or do they think they are dealing with a salesperson in a buyer beware context, in whom they would place no more trust than they would when buying a used car?

Defense statements filed in a $10,000 small claims action ***(Ontario court file 03-SC-083313 Norah Cosgrove verses Nancy Kemball, Richard Shantz and RBC Dominion Securities)*** shows the defendants claiming that they owe the 92-year-old widowed client (and perhaps the majority of their other investment clients by the same logic) “no duty of care”. Having previously worked for RBC for 17 years, I know they are a high quality firm, however this legal maneuvering has dire implications for the level of trust of the investment industry.

I don’t know if this client contributed to their own account problems, as can happen, but I do know that to claim a defense of “having no duty of care” because an account is not a discretionary account would not be helpful to the industry.

Ethical codes of conduct, industry training manuals, regulations, and millions of dollars of advertising promise a duty of care to clients and an advisory relationship you can trust. To claim otherwise as some investment firms are doing is to try and deny the obvious in my opinion.

In another case, that of Melville and Marion Hunt, a retired couple in their 70’s from Kitchener Ontario (Melville has since passed on), from the writer's perspective the Ontario Court of Appeal judge erred grievously when he ruled that the trust that the clients had placed in the hands of their advisor was “unwarranted” because they opened a non-discretionary account. There may have been other reasons involved, but to say that a non discretionary account (the kind of account most of us have) is reason enough to allow self-serving behavior is to negate the advertising and promise of trust of the entire industry. ***A. Melville Hunt, et al. v. T.D. Securities Inc. c.o.b. as TD Evergreen, et al.*** **(Ont.) (30026)** Either this is indeed an error, or investment firms need to change millions of dollars of advertising in order to represent themselves truthfully.

A “non-discretionary” is the most common account in Canada. It is an account where each buy or sell transaction needs discussion between client and advisor before proceeding. The client has not given “discretion” to the advisor to make all decisions in isolation. A discretionary account, on the other hand, is an account where the advisor makes decisions and changes without client input. Some might say non-discretionary is "safer" for the average client since there is a required discussion prior to all trades.

Discretionary accounts are usually reserved for those investors who are wealthy enough to let someone else handle the daily management of it for them. If investment dealers say they owe no duty of care to clients who do not have discretionary accounts, are they saying that the majority of investors in Canada are in a "buyer beware" relationship? The advertising promises say otherwise.

In the Hunt's case, their advisor sold off a portion of their BCE shares without obtaining the authorization of the client (facts of the court finding 2001). This act in itself is illegal. But by a twist of logic the end result (August 2003 Ontario Court of Appeal) states that since the client did not have the discretionary type of account, (since the client did not hand over complete control of the account to the advisor..........) they do not owe the client a duty of care (a duty to place the interest of the client ahead of the advisor). Though the firm had broken the law by making unauthorized trades, it did not seem to matter. If this does not make sense to you don't feel bad. I am having a hard time with it myself, and I have just over twenty years in the industry. As I mention earlier, there may well be some contributory factors by the client that added to his or her damages, but if the argument is that we don't owe you anything if you have ***this type*** of account, I would find this a dangerous and industry damaging precedent.

For the investment industry, this would send a message directly opposite to that which it is trying to send, that being, "trust us, we will place your financial situation on a solid foundation, and we will use our expertise and experience to your benefit". Rather it sends a message of, "we just might take ***your money*** and ***our experience***, and make it ***our money*** and ***your experience***".

Rather than defend (or condemn) the actions of some of it's rogue brokers, which would at least allow for an open airing of the issues, claiming no duty is a slap in the face of those clients who trusted the firm and the advisor. This is not a defense of the issues involved, but rather a dismissal of the issue. There are a few legal reasons why they may feel they have to take this approach. Let me give you the example I started out with and then an attempt to explain why they may feel they have to do this.

92-year-old Norah Cosgrove, of Toronto, with the help of her daughter, brought a claim of $10,000 against the firm she dealt with for years, claiming her investments were altered without her permission or understanding. The investments were changed to increase the amount of risk in the accounts, and it coincidentally increased the amount of compensation to the broker.

The firm refused to take responsibility for the alleged act of discretionary trading in this account, and has seemingly attempted to trump the entire process by denying that they have a responsibility to the client at all.

The statement of defense, filed in Ontario Small Claims court, RBC states in Para 16, " At no time were the defendants acting in a fiduciary capacity..........." This despite the industry striving and advertising heavily to state otherwise, and despite definitions of fiduciary that state "the relationship of the broker and client is elevated to a fiduciary level when the client reposes trust and confidence in the broker and relies on the broker in making business decisions". (Case law Merit Investment Corp v. Mogil, J Anderson, March 23, 1989 Ont. H. C. J. (summarized at 14 A.C.W.S. (3d) 378)

Perhaps firms may feel they have to take this approach, hoping time will cause the public to forget, or not find out about this particular conflict. This because if investment firms were held to their promise to care for clients (fiduciary level of conduct), they then have some billions of dollars of explaining to do for making recommendations that were in the dealers best interests and not clients best interests. Courts have commented that dealers are not supposed to use their experience and expertise to take advantage of people who go to them for advice. They are not to benefit themselves financially from the fact that clients may be at times uninformed, trusting and vulnerable.

The solution to this may hopefully be found in proposals such as the Fair Dealing Model, created by some forward thinking folks at the Ontario Securities Commission. They have, I believe outlined some rather clear and simple rules that clarify and solve the buyer beware problem. Visit the OSC website and view the FDM proposal at:

http://osc.electramedia.com

After twenty years in the investment industry, the author is using his experience to try and correct some of the negative aspects of the industry. For further research on the topic of "Investor, Buyer Beware", visit the Small Investor Protection Association at www.sipa.to or http://regulators.itgo.com/PI/PI_Complete.html for a list of articles on investor abuse.

"The writer provides these comments from the perspective of having been involved in the investment industry for 20 years and finds it needs an improvement in the words promised and the deeds delivered. The writer does not have legal training and this article is not intended as a legal analysis, but rather a simple personal opinion of right verses wrong based on twenty years experience.

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DOUBLE DIPPING

Is your advisor charging twice for advice?

As the investment world evolves, we find that the changes happen so fast, that the regulatory environment cannot keep up. This leaves only the ethics of an advisor or an organization to handle the conflicts that arise on a daily basis. Here is just one situation that I have witnessed that is being conveniently overlooked to the detriment of clients, and the advantage of advisors.

It is called double dipping and it is the practice of earning fees twice on the same investment. Here's how it goes:

Your trusted advisor comes to you suggesting that you sign up for a new type of investment management process, where an annual fee is charged for services, rather than a commission charge per transaction. You agree that it sounds sensible and tell them to go ahead and convert your current investments over to this style of payment. The double dipping test is, "will your account then pay a transaction charge either to sell or redeem your current investments, in order to change to the annual fee type of arrangement?" If so, there may be something wrong. The other double dipping method we see is to first charge the client a commission on a mutual fund for example, or have your advisor earn a commission and then change these investments into a fee based account, thereby earning a fee on top of a commission.

Either way you have just been double dipped. In the case of the mutual fund, given that there is usually a trailer fee earned (a percentage of the annual management fee) by the firm and the advisor, you may actually be enabling your trusted advisor and the firm to earn as many as three fees on the same investment.

I have also heard of client's accounts, which are full of new investment issues. Why? Because some advisors have discovered that if you have a fee based account for a client (which pays an annual flat fee to the advisor), and inside this fee based account you purchase new issues, then you are getting the commission from the new issue piled on top of the flat annual fee. Twice the revenue for the advisor.

This is considered unethical as well as illegal in the United States. In Canada it occurs since the practice is slightly ahead of the regulations, (or the regulations in Canada are a bit behind). Ethics would of course dictate it not be done, but as we have seen, some firms and advisors only look at the rules and not at the ethics of a practice if that suits them. Rules cannot be expected, nor were they intended to cover each and every indiscretion that blind ambition can invent.

Double dipping is the invisible client killer that occurs in some cases, and I look forward to the day when firms recognize this and stop looking the other way because of the revenue it generates. I have seen large bank owned firms who are fully aware that this practice is wrong, defend themselves when questioned by clients by saying that, “we gave you a discount on the third fee, so you should be satisfied”.

What good is an industry built on trust if they can so easily and commonly justify self-serving behavior?

SECURITIES ACT RULES IGNORED FOR SELF INTEREST

<u>One example</u>

PART 3 of the *Securities Act* outlines clearly the PROFICIENCY REQUIREMENTS FOR ADVISERS. Why is it that the industry ignores these requirements and calls its members any title it chooses?

When I worked for RBC they arbitrarily changed the title of every person registered as a stockbroker after the stock market crash of 1987. They were changed to that of investment advisor, against securities regulations, but in favor of the marketing of the industry. It was clear then, and remains true now, that only a fraction of those people met the qualifications to be using the title of investment advisor under securities regulations

> (Proficiency requirements for ADVISERS under the *Securities Act* (Ontario) can be found in section 3 of Rule 31-502.)

Are you dealing with a licensed and registered professional? Or are they simply calling themselves something for marketing purposes? Is this proper or a violation of securities rules for self-interest?

How are they registered?

What do they call themselves?

Why are the banks that own these brokerage firms now allowed to also arbitrarily change the title of some 16,000 bank account officers to a similar title of "investment advisor" or "financial planner", simply for marketing purposes.

This is yet another example of how the industry ignores rules intended to inform or to protect the public, if it is in the self-interest of the industry.

ADVISORS MIGHT BE SALESPERSONS IN ADVISOR CLOTHING

How do you tell if you are dealing with a trusted advisor..verses a salesperson in advisors clothing?

Your advisor suggests you buy a global growth fund. The particular fund suggested has several "classes" of units to choose from, which are for all intents identical except for variation in fees paid to the advisor, and costs incurred by the client. The advisor advises you to purchase a particular type of unit and unless you read the legal prospectus, you may not be aware that the choice you were advised to make was the one which compensated the advisor the most, and incurred the highest liability to the client.

This situation is very common and easy to identify. It happens to be one of the key signs that in my opinion will indicate whether you are dealing with a true "trusted advisor", or simply a salesperson, acting as an advisor. A wolf in sheep's clothing. **It comes down to three letters. "DSC". DSC stands for Deferred Sales Charge**. It indicates that your advisor induced, encouraged or advised you to obtain your mutual funds units using perhaps the highest potential sales cost choice to you, and, the highest compensation choice available to the advisor. (Approximately 80% of the investment funds in Canada are or were sold with the DSC commission option.)

I am talking about investment recommendations that are made based on, ***"what choice will create the greatest income to the advisor",*** and not on what would most benefit the client.

If people were fully informed of the different options available when buying mutual funds, most would not choose the one that earns their advisor the most, and makes them pay of become liable for the greatest penalty. You will not find this information disclosed on your purchase confirmation, nor on your account statement. It is **effectively hidden** from the average client. You may not have even been told of the choices available to you.

So ask yourself the next time you purchase a mutual fund in Canada. Is the rep telling you of the various ways in which you can purchase them, the commission options available in a deregulated world? Is he or she acting in your best interest, or are they just "acting" as a trusted advisor? Cases in the United States have started to find that this kind of self-serving "advice" is in fact unsuitable, and worthy of compensation paid back to clients.

Are you under the impression that your advisor is likely to suggest to you the ***highest cost alternative***, if it is to their advantage, and is that indeed advice, or a sales story in advisors clothing?

CODE OF SILENCE

I worked for a bank that had a code of silence. I worked for a bank that also had a code of ethics. I cringed when I saw the code of silence take priority over the code of ethics. It happened over and over again.

The code of silence is not called that of course, except by employees. To the outside world it is a normal policy that prevents employees from talking on any issue without prior approval. It could even be considered reasonable in order to present a single side on an issue, and not have every member of the company speaking at once. It also may be a violation of the Canadian Charter of Rights and Freedoms on freedom of expression.

Where it causes me to cringe is when unethical behavior or client abuse gets ignored or covered up to protect the troops or the revenue. When this happens, the typical reaction of management is to look the other way, pretend nothing happened. Stay the course and don’t lose sight of that year-end bonus.

Anyone speaking up on the issue is immediately silenced, and threatened. Avenues of complaint within the firm such as the compliance department are returned to your immediate manager, who may or may not be part of the problem, and is usually not willing to become part of the solution. The solution is to shut up the complaint. Any possibility of going outside the firm is met with threats of dismissal, written or otherwise. Life gets incredibly difficult for the person.

One example was when mutual funds used to send top sellers of their funds on exotic trips. The media got wind of this and started asking questions of the industry. Employees were told that immediate dismissal would result for anyone speaking about this. Once it was clear that the issue could not be held in silence, the firm did a 100% about face, and changed its policy to reflect the public interest. It was not done voluntary, nor done willingly. It was clearly a case of the code of ethics being covered over by the code of silence.

The current issue that is example of client abuse being ignored and covered by the code of silence is that of double and triple dipping of clients with mutual fund purchases and fee based accounts.

Another example is gagging investment advisors from speaking, educating, or writing publicly about ways to purchase mutual funds without sales fees. This has caused the big commission producers (the vice presidents) to fear a loss of commissions and circle the wagons against any advisor wishing to be more competitive and less self-serving. Most IDA firms still have in place an internal code of silence that allows new forms of client abuse to grow and foster as the investment world changes and opportunities for self serving behavior present themselves.

REQUIRED SOLUTIONS:

Rid the IDA (Investment Dealers Association) of having ***any*** self-regulatory role whatsoever. They are a trade organization and as such are most interested in their members. They are equivalent to allowing the foxes to watch the henhouse and they are quite understandably not doing the job of protecting or compensating the public. See http://regulators.itgo.com/PI/PI_Complete.html for dozens of stories to support this.

Enact the OSC Fair Dealing Model immediately to clearly define the roles and responsibilities between advisor and client, with less ambiguity or "wiggle room" for unethical advisors or firms.

Empower a client advocate or ombudsman, with power to enforce regulation, and impose client restitution for industry abuses. This person/organization should be strictly arms length from the industry.

Move toward a single regulator in Canada.

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