

December 17, 2012

**COMMENT LETTER /SUBMISSION MUTUAL FUND FEES**

**CANADIAN SECURITIES ADMINISTRATORS  
DISCUSSION PAPER AND REQUEST FOR COMMENT 81-407  
MUTUAL FUND FEES  
December 13, 2012**

[http://www.osc.gov.on.ca/documents/en/Securities-Category8/csa\\_2012123\\_81-407\\_rfc-mutual-fund-fees.pdf](http://www.osc.gov.on.ca/documents/en/Securities-Category8/csa_2012123_81-407_rfc-mutual-fund-fees.pdf)

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**--- A cigarette industry like disclosure that might catch retail investor attention**

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The CSA Consultation Paper pulls back the curtain to reveal the extent to which the structure of the Canadian investment fund industry impedes professional advisors and others from being able to act in the best interests of their client. We congratulate the CSA on the detail, depth of understanding and quality of the background material provided. The plain language exposition and use of charts may encourage more retail investor participation in the Consultation.

Kenmar Associates is pleased to comment on this Consultation paper. We have studied mutual fund fee structures and their adverse impact on retail investors for nearly 20 years. The CSA cite research showing “mutual fund investors tend not to review disclosure documents for cost information and instead primarily rely on advisors to tell them about costs,” and add “further research indicates that many advisors do not tell their clients about costs.” This highly correlates with our own work with complainants especially switch fees and early redemption penalties. There is abundant research to demonstrate that trailers constitute a conflict-of-interest issue whether or not costs are disclosed. In the case of advisors, the CSA note there’s “no evidence to substantiate” that investors can expect an increase in services and advice if their fund’s trailer commissions rise. In fact, we witness, with few exceptions, very little in personalized advice beyond “Buy-and-Hold;”, “Invest in your RRSP”, “Borrow to Invest”, “Active management is superior to indexing”, “Dollar cost averaging is the Best way to reduce risk”, “Use this Model Portfolio” and the like. Selling is priority #1.

Trailer commissions amplified by attractive compensation grid structures are the root cause of aberrant behaviour although lack of professional qualifications may be a factor as well. In fact, we have been successful in a significant number of complaint cases against dealers/Reps based on incorrect advice on RRSP loan interest deductability, misunderstanding ROC funds, portfolio “de-worsification”, and incorrect interpretation of TFSA rules. [ When we consult the rules, regulations and Bulletins of the CSA and the MFDA/IROC we do not find regulations defining the nature of “advice” or the parameters in which that advice should be delivered, monitored and reported. Regulations relate mainly to issuance of securities and the rules and regulations governing their transactions and the rules and regulations governing the disclosure, sale and purchase of securities for individuals. ]

In a nutshell, our observations on the mutual fund industry are:

<sup>35</sup><sub>17</sub> Canadian mutual fund fees are among the highest fees in the world as supported by numerous independent research studies [ portfolio transaction expenses add to investor costs but are not included in the MER] . Needless to say, this severely impairs Canadian retirement pensions. In an updated analysis, investor advocate and independent financial analyst Diane Urquhart. concludes that about half of investors will have their returns eaten up by fees over 30 years. She finds that if Canadian fees were closer to the world average, Canadian investors would have almost 25% more in retirement savings. Her analysis assumes a 6% average annual return over 30 years, an average total expense ratio (TER) of 2.2% in Canada, and a 0.95% TER in the rest of the world. Those estimates are drawn from a 2007 academic paper *Mutual Funds Fees Around the World*.

<sup>35</sup><sub>17</sub> In the absence of government regulation, retail investors assume their “adviser” is trained, certified and held accountable in providing professional financial planning. The sad fact is that most “advisors” are acting as salespersons with no regulatory requirement to provide financial planning or indeed, any particular advisory service. This huge regulatory gap is what the CSA

appears to finally be trying to close. [ A 2012 OSC IEF study concluded “ ..Two-thirds of investors know little about their advisor when they enter into a relationship with that advisor. Only one-third gets to an advisor through a referral. The most common way to get an advisor is to have one assigned by a bank or financial institution. Investors trust this assigned advisor, because they trust their financial institution to do what is best for them...” ]

<sup>35</sup><sub>17</sub> Fund manufacturers can raise trailer commissions without having to obtain investor approval through a unitholder vote. Prospectuses are foggy on trailers using terms such as *up to* or *may pay* to disclose trailer information.- no information is revealed as the portion the Rep actually receives. Manufacturers simply allocate a greater part of the disclosed management fee toward trailers as a business decision. Higher trailer commissions encourage increased sales activity and thus higher sales, thus increasing a fund company’s fee-earning assets and thereby generating still more management fees. There is no evidence that higher trailer commissions result in more or better service to investors. The reverse seems to be true.

<sup>35</sup><sub>17</sub> Trailing commissions ( it might be better to plain-language label them as “Ongoing sales commissions.” so retail investors aren’t caught up in industry jargon) are the engine for distribution – according to IFIC , the percentage of investors using an advisor” [ actually a dealer Rep] for their last purchase has varied between 81% and 85% since IFIC began conducting its Investor surveys in 2006.[ if trailers were prohibited, we suspect fund sales would decrease unless the value of the advice provided could be demonstrated.] The average financial adviser now earns 64 % of his/her compensation from mutual fund trailer fees, up from just 27 % in 1996 which explains the aggressive sales approaches and the use of leveraging to magnify sales.

<sup>35</sup><sub>17</sub> Current disclosure of fees is ineffective ; indeed, disclosure as a foundation of regulation is a weak investor protection according to recent academic studies. The 2012 OSC IEF study ( pg 28) found that 51% of investors had no view as to whether there was a conflict- of-interest or not. Among this group, the majority (29% not aware, 22% aware) indicated that they were not aware of all these sales commissions prior to the survey. Others said they were aware, but hadn’t formed an opinion. Among the half of investors with an opinion on conflict -of-interest, an astonishing 73 % [ 36/49] believed that their advisor would look out for their best interest regardless of how the advisor was paid. This is a BIG Red flag for regulators.

<sup>35</sup><sub>17</sub> Retail investors do not understand the adverse impact of fees over time i.e the de-compounding of returns [ studies show majority of mutual funds do not meet benchmark over 10 or even 5 years] . This results in clients losing a significant amount of market returns over a 20-30 year investment horizon due to fees.

<sup>35</sup><sub>17</sub> Retail investors wrongly believe fund salespersons are advisors acting as fiduciaries [ industry marketing materials often encourage this misunderstanding]

<sup>35</sup><sub>17</sub> Wrap accounts add costs but yield questionable benefits .The CSA confirms our experience with wraps. Over the last several years, wrap accounts ( fund-of-fund products) have grown in popularity, now accounting for approximately 47% of long-term mutual fund assets under management, up from 37% in 2006 .Wrap .accounts hold substantial appeal for Reps since they are per-packaged mutual fund investment portfolios which eliminate having to do any fund selection and asset allocation . In the case of a wrap, the advisor need only assess the suitability of the top level fund rather than assess the suitability of every fund in the portfolio.

Notwithstanding the dramatic workload decreases that wraps provide for dealer Reps, the trailing commissions payable on wraps are the same or higher than on stand-alone equity mutual funds. We have found no evidence clients obtain more face time with Reps; instead we are told , the time freed up is used for prospecting for even more buyers. Fund manufacturers also gain by sales [ AUM] of their own proprietary funds rather than using Best-in-Class funds. The client ends up with a package of expensive funds whose asset allocation is not tailored to their individual needs, personal situation and objectives.

<sup>35</sup><sub>17</sub> Industry rarely presents dollars and cents expense information on client statements.

<sup>35</sup><sub>17</sub> Embedded commissions lead to investor abuse, not just reduced returns. e.g. Churning , excessive leveraging , defective asset allocation etc. The lack of fiduciary duty not only provides skewed advice but allows dealer Reps to withhold better recommendations ( like ETF's or reduction of debt) that would benefit investors. In more extreme cases, the drive for sales leads to NAAF adulteration, signature forgery or even abuse cases like the infamous Ian Thow case.

<sup>35</sup><sub>17</sub> Fund manufacturers pay online brokers a trailer but no service is provided- at a minimum ,this is a breach of portfolio manager fiduciary duty; worst case: an illegal misappropriation of fund assets. Why not simply prohibit the payment of trailer commissions to discount brokers? [ IRC's should be dealing with this governance issue, but despite widespread visibility, they have not]

<sup>35</sup><sub>17</sub> DSC and FEL MER's are often equal, but math says they should not be . Some firms automatically convert to FEL series upon the completion of the DSC period. But even here , conversion to a FEL fund ,while it does eliminate the redemption constraint ( improve liquidity) , adds to client risk by upping the trailer commission paid to Reps.

<sup>35</sup><sub>17</sub> DSC in RRIF' s can be a killer for seniors because of minimum annual withdrawal requirement [ early redemption penalties run into the tens of millions of dollars annually].Based on our experience, lucrative trailers are the motivation for the sale of DSC funds in RRIF's and RRSP's. Note that DSC penalties cannot be offset against capital gains in registered accounts. Such irrecoverable penalties impair account returns for retirees and pensioners.

<sup>35</sup><sub>17</sub> Poor disclosure of fees and almost no personalized performance reporting equals undetected lousy portfolio performance for retail investors. An “advisor” who cannot provide performance reports cannot, in our view, be providing sound investment advice. Without knowing returns , investors cannot measure if their investments are tracking their future needs. If account returns reporting were mandated by regulators, investors would also be able to assess the quality of advice they are receiving. This past June, Boston-based DALBAR Inc. released its 2012 Trends and Best Practices in Mutual Fund Statements Study. Relative to other financial services sectors, the study says, mutual fund statements do not provide value-added account details that give investors a well-rounded and complete view of their investments. The majority of mutual fund statements provide only the most basic levels of detail, such as account values, individual holdings and transaction activity.

<sup>35</sup><sub>17</sub> According to 2009 IFIC data, close to 50% of mutual funds are held by Canadians approaching or in retirement, and close to 70% of holdings in RRSPs are mutual funds. This should put regulators on HIGH alert given the known vulnerabilities of seniors.

<sup>35</sup><sub>17</sub> With low interest rates and slow economies, mutual fund returns after fees, taxes and inflation equals about ZERO [ most fund investors have no idea of their personal rate of return]

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- <sup>35</sup><sub>17</sub> MER seems independent of fund size i.e. as assets grow, MER is invariant
- <sup>35</sup><sub>17</sub> F class are not available to DIY investors but high integrity firms like Steadyhand and Mawer sell directly albeit initial investment minimums are higher than for mutual funds sold via Reps.
- <sup>35</sup><sub>17</sub> Fund governance a big issue still ; IRC's not very robust – they have no impact on fees levels or structures [ In effect , trailer commissions put mutual fund manufacturers in a conflict -of-interest because they benefit by raising the trailer rates to attract “advisers” to their funds (and hence increase AUM) , but they are also supposed to act in the best interests of the fund itself. Increased AUM benefits the manufacturer rather than the fund itself . This governance situation should not be allowed to continue ] Conflicts-of-interests abound with retail investors always at the bottom of the food chain.

It has been well recognized for decades that mutual funds are sold, not bought. Brokers refer to their registered representatives as “producers”. It is every registered representative’s goal to be a “Top Producer”. This means that he is among the top ranked generators of sales commissions for the firm, and is among the highest compensated agents. As in any sales culture, compensation is the ultimate benchmark used to measure each registered representative’s effectiveness. Some firms have what is known as a “million dollar roundtable”. In order for a registered representative to sit at this table, he/she must generate more than one million dollars in commissions for the year. Perhaps they will receive a plaque and special recognition at the annual sales meeting. Top producers might win a new set of golf clubs, theatre tickets or some other form of non-cash compensation. Fund manufacturers help sponsor “ free lunch” seminars where mutual funds are flogged. Clearly, it's not just financial incentives that are used to drive “adviser” [mis]behaviour. The abusive sales culture starts at the top. An old Middle Eastern saying reminds us that “ *A rotten fish stinks from the head*”. The only way to real reform is to deal head on with the sales culture issues and the related compensation issues.

The mutual fund industry employs an arsenal of sophisticated techniques to market mutual funds so it is understandable, in the absence of protective regulations , that Canadians are paying top price for mutual funds. These techniques include (a) misleading or confusing advertising \*; (b) “Free lunch “ seminars; (c) publication of biased investor surveys ; (d) inflated titles for “advisers”; (e) wrap accounts which help complicate fee disclosure and understanding (f) specialized sales training and commission plans that assist mis-selling under the prevailing suitability regime and (g) uninformative client statements with no reporting of individual account performance. The highest trailer commissions are paid when clients purchase equity funds over other fund categories, although very few clients know this- this helps explain the lopsided portfolio compositions we too often see. The bottom line is that most mutual funds are not providing a robust or economic path for Canadians to save for retirement. Reforms are required and have been required for many years since the Stromberg Reports identified the key mis-selling issues in the late nineties.

\* A recent Staff Notice from the Ontario Securities Commission found that many investment fund managers are preparing marketing materials with information that is misleading or contains unsubstantiated claims. For example, some fund managers use terms such as "best", "exceptional" or "leading" to describe the performance of their investment funds without also including evidence to support these claims.

Funds managed by banks, typically sold without commissions, account for 43 % of industry assets. Funds managed by independents, typically sold with commissions, account for 49.4 % of industry assets. This could be why we see far fewer complaints from bank branch sold funds. Our conclusion

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may not be statistically significant but we expect we are correct. OBSI may be able to break down statistics to increase statistical validity.

IFIC's 7th Annual Landscape Survey ( issued Oct. 3, 2012) asked mutual fund owners to rank mutual funds, GICs, stocks, bonds and ETFs according to how much confidence they have in each product to help them achieve their financial goals. Mutual funds achieved an 80% confidence level compared with 68% for GICs, 59% for bonds, 56% for stocks, and 31% for ETFs. Fund investors also continue to express a strong preference for receiving information about potential fund purchases from their advisor (81%) and for using the advice channel to make their fund purchases (85%). Given the many potential investor abuses revealed in the CSA Consultation paper , these statistics should raise a number of RED flags for regulators.

As independent research clearly shows , fees are the primary cause of sub-benchmark fund performance. The CSA analysis shows that a typical equity mutual fund charges an annual management fee equal to 2 % of the fund's asset value. Trailer commissions account for half the cost on average, or 1 % of a fund's assets, although the rates vary, depending on the fund. If the advice provided has value it must be sufficiently high to overcome the drag of fees. It should also be noted that while trailers are a major cause of fund under-performance , other so-called optional fees are not immaterial-sales loads,early redemption fees ,switch fees, currency conversion fees ( mostly in registered accounts) and account transfer charges also take a nasty bite out of retail investor nest eggs. [Across all mutual fund classes, the CSA research found mutual fund management fees totaled \$13.4-billion in 2011, with trailer commissions accounting for \$4.6-billion or 34 % of the cost. At the end of 2011, the mutual fund industry managed \$762 billion in assets on behalf of an estimated 12 million Canadians.]

Among the possible options set forth in the Consultation paper, the CSA suggest that: trailers could be banned outright; or, there could also be a maximum limit set on the portion of mutual fund assets that could be used to pay trailing commissions. It also suggests: a minimum level of ongoing services that advisors must provide to investors in exchange for trailer commissions could be established; mutual funds could be required to provide a class of funds for do-it-yourself investors that pay no trailers; trailers could be unbundled and charged/disclosed as a separate asset-based fee; and, a separate series of funds could be required for each purchase option. Additionally, it suggests that regulators could impose a "Best interests" duty on advisors, as is being examined in a separate discussion paper, in order to mitigate conflicts. We need to stand back and look at what we are actually paying for. If this is purely a transaction with the fee coming for the advice on the transaction, then in a competitive market place you should be able to buy mutual funds without the load and without the embedded trailer if an investor does not need or want the transaction advice. That is unfortunately not the prevailing model and therein lies the core of the issue [ we are aware that a few online brokers may rebate trailers for a modest fee].

We support a “ Best interests “ regime but suspect it is probably years away from reality given the intense industry lobbying to prevent,delay or water down implementation.

*“It will not be possible to do away with commissions in Canada unless you can break the very strong link between product distribution and the investor, and “advisors” have fiduciary type*

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*responsibilities towards their clients. You pay for a service, and you pay for advice, and until you are actually paying for accountable and regulated advice and not the transaction, moving to a fee only industry cannot happen effectively.*” - Industry observer Andrew Teasdale

Until advice is actually regulated in some shape or form, financial standards are raised and financial advisors have a real professional body to define the rules and regulations governing the provision of advice and to discipline and punish those who ignore them, the retail investor will need to be responsible for policing his/her own financial position- an unattainable goal given all the facts we have.

Clearly, banning trailer commissions outright would be the most straightforward way to align the interests of both the mutual fund manufacturers and the dealer Reps ( advisors) with those of investors. The entrenched Canadian business model of financial firms is an enormous challenge to actually foster integrity and trust. Other countries are clearly willing to be bold re investor protection. Canada is falling behind the United States, the U.K. and Australia in eliminating the conflicts-of-interest that harm retail investors and enrich industry participants.

All of the possible options presented by the CSA are clearly a long way from being adopted given intense industry resistance and self-interest. Yet reforms are clearly needed now as Boomers enter retirement and honest, trusted professional advice is desperately needed by many. According to the CSA Consultation paper, mutual funds are the most commonly held investment product, with nearly two thirds ( 62 %) of Canadians with savings or investments set aside holding them in their investment portfolios. As at June 2011, the average Canadian household held 36.1% of its investable assets in mutual funds, the largest share of investable assets for the typical Canadian household. Given the many issues with mutual funds, trailer commissions create a very significant socio-economic issue.

We note that the CSA intends to monitor the impact of ongoing disclosure initiatives, such as the introduction of Fund Facts disclosure documents and new cost and performance reporting requirements, to determine whether these initiatives appreciably improve investors' awareness and understanding of mutual fund costs, make them more informed consumers of investment fund products and advice services, and promote effective competition among financial industry participants. We add parenthetically that Fund Facts does not contain a cautionary warning re conflict-of-interest as is the case in the equivalent US document. It is our conviction that conflicts-of-interest are so fundamentally harmful that they should be dealt with now by regulators. Even with heightened awareness, the limited financial literacy and numeracy of Canadian mutual fund investors, information/knowledge asymmetry and perfected adviser sales pitches will keep ordinary Canadians vulnerable to mis-selling. Studies elsewhere in the world provide clear and convincing evidence that only the prohibition of trailers will stop the commission-driven abuses. Action, not more monitoring, is required to protect retail financial consumers. We do not need to reinvent the wheel to make advice professional.

A professional advisor can help people make the right financial decisions, decisions that are not blurred by dual loyalties. In some cases, the fee for advice, can be deducted as an expense, a tax advantage not available to investors in embedded commission funds. The scope of decisions range from budgeting, debt management, and financial planning to investing for retirement, insurance and estate planning. A professional advisor is well educated in the field (s) he/she is registered in. Depending on issue complexity, specialists in such areas a taxation, life insurance or estate planning

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may also be called in. Professional advisors have a fiduciary duty to clients . Traditional embedded commission advisors paid by mutual fund companies need only provide products that are “suitable” for investors. Most such advisors may have taken no more than a correspondence course and passed a multiple choice exam to be licensed. If even as only a transition move, the **qualifications** of “advisors” must be increased if the title *adviser* is to be permitted. ( otherwise, regulators should mandate the title *Salesperson*) .Quebec regulators appear to be on the right track here and we recommend an assessment of their approach.

The fund industry argues that investor education, not regulation, is the way to salvation. This is a diversion. Indeed , a paper by Professor Lauren Willis *Against Financial Literacy Education* argues against too much emphasis on education. The professor believes the day of the informed investor is implausible, given the velocity of change in the financial marketplace, the gulf between current consumer skills and those needed to understand today's complex non-standardized financial products, the persistence of biases in financial decision making, and the disparity between educators and financial services firms in resources with which to reach consumers. The search for effective financial literacy education should be replaced, the author states, by a search for policies more conducive to good consumer financial outcomes. [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1105384](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1105384)

The Small Investor Protection Association ( [www.sipa.ca](http://www.sipa.ca) ) obviously agrees. In its submission to the Task Force on Financial Literacy , President Stan Buell remarked:

*“ ..The financial services industry is also important to Canadians. They are led to believe that they can trust the financial industry. The media advertising suggests that early retirement is possible by placing trust in the industry. Slogans like “Freedom 55” encourage this belief. Products with names like “Income Trusts” or “Principal Protected Notes” sound secure, although many Canadians have lost their savings when they were concentrated in these products. Canadians are told that the financial services industry is well regulated, and that investors are protected. In 2004 the Senate Committee held that belief, as do most Canadians, however their hearings revealed a much different story..”*  
[https://www.financialliteracyinCanada.com/documents/consultation/Small%20Investor%20Protection%20Association%20\(SIPA\)\\_Buell\\_Stan\\_29%20April.pdf](https://www.financialliteracyinCanada.com/documents/consultation/Small%20Investor%20Protection%20Association%20(SIPA)_Buell_Stan_29%20April.pdf)

We support the Best interests standard and the banning of sales commissions for those holding themselves out as investment advisers. In the interim, until we reach the promised land , we suggest the following actions be taken now:

1. Require personalized performance reporting without undue delay [ against market benchmarks AND a 5-year GIC return ]. This will open the eyes of investors and encourage constructive dialogue with advice givers.
2. Improve the NAAF form/KYC process to correct known deficiencies .
3. Improve Fund Facts risk, fee and conflicts disclosure , move fee disclosure ahead of performance and require FF delivery to clients prior to purchase.
4. Make dealers pay fines: It's well known that regulators collect only a tiny fraction of the fines imposed on dealer Reps. whom they hold responsible for investor abuse. We therefore argue that the deterrence value is NIL. We argue that the advisory contract is with the dealer NOT the individual Rep. Imagine if aircraft manufacturer Boeing practiced this way. An aircraft

maintenance technician would be held responsible by the FAA- Boeing would be off the hook even if the plane went down. Our view is that the dealer recruits “advisers”, trains them, incents them to meet sales quotas, provides the systems , policies and practices under which they operate and supervises them plus assigns a compliance officer to quality control the whole process. The dealer gains from the active selling but when the person at the bottom of the food chain gets caught, the firm walks away. This is an attack on natural justice that ends up leaving trusting clients on their own. The latest MacQuarie-OBSI fiasco is an illustration of this malpractice. Dealers like it this way because they are immunized from wrongdoing and Reps like it because they know IROC/MFDA can't collect the fines. The only loser is Main Street. Note that OBSI rightly always holds the dealer responsible for wrongdoing by "advisers" .The dealers " Trust us " marketing materials hold out the promise of integrity and fairness. It is the dealer who makes declarative statements and ads re trustworthiness and it is the dealer that should be held accountable for fines.

5. Encourage competition by allowing Canadians access to lower cost U.S. Mutual funds
6. Clarify exactly what these trailer commissions buy\*, if anything, for clients. This could be weaved into Fund Facts and the Simplified Prospectus. CSA educational literature would have to be updated to reflect the true nature of embedded commission registered representatives. ADD a bold-faced warning on all sales communication documents highlighting the conflicted nature of the Rep-client relationship [ see sample at beginning of this discourse] .

\*By examining CSA/SRO complaint investigation data ( and our own case histories), we can infer that as a minimum , registrants are expected to recommend “suitable” investments per KYC , establish reasonable asset allocations, not churn accounts and should not recommend leverage when it is not appropriate . There does not appear to be any legal or other obligation to assist in budget/ debt management, provide lowest cost portfolio solutions,prepare an IPS, monitor the portfolio after the transaction , provide portfolio performance information or provide a financial plan . Any advice relevant to income tax matters appears to be very basic and incidental to the transaction. Fund marketing literature suggests that such services may be provided but smart legal language protects dealers and fund manufacturers from litigation. Despite this reality, IFIC, the investment fund industry lobbyist states “ *...**Holistic/big picture thinking:** Holistic/big picture thinking is more than product knowledge. It involves risk management, tax planning, succession planning, living benefits (such as long-term care insurance and disability) and estate planning. Financial advisors may offer some or all of these services. If they cannot provide a specific service themselves, they often have access to a network of professional colleagues that can assist in these areas. ...*” Source: <https://www.ific.ca/Content/Content.aspx?id=3728>

One last point. Fair complaint handling is particularly important for all investors, particularly seniors. In our view, investment complaint handling in Canada is exploitive. Too many valid complaints are rejected by the mere issuance of a form letter claiming the dealer is not at fault. The very public attack on the Ombudsman for Banking Services and Investments (OBSI) is symptomatic of anti-investor behaviour by the financial services industry. A number of cases, some by the elderly, have been `stuck` in OBSI for well over a year. Regulators need to meaningfully enforce the requirement that complaints be handled fairly and in a timely manner. Regulatory rules need to include requirements for detecting and promptly dealing with systemic issues . What is ultimately necessary is a clear path to financial restitution which doesn't exist now except through the difficult and expensive civil litigation process. [ OBSI only provides a *recommendation* for restitution. Recently, due to industry intransigence, OBSI

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has been forced to issue “Name & Shame” News Releases which appear to have had little effect on apparently shameless dealers.] Conclusion? OBSI recommendations should be binding on dealers .

One successful tactic used by fund industry lobbyists is to push regulators into having to cost-justify even the most obvious and basic reforms. We have a definite view on Cost-Benefit analyses. Our experience is that they are very difficult to do for regulatory matters and are often a numbers game. The costs are always inflated by industry and generally understated by regulators. Benefits can be elusive unless one accepts that not duping customers is inherently the right thing to do. One could try to estimate all the wrongdoing and high fees that could be prevented/avoided by the regulation and present it in dollar terms. In some cases the benefit may accrue to the State by avoiding an increase in social benefits to victims of mis-selling. In any event, so many assumptions need to be made that industry can always shoot holes in any analysis. In the present case, it is our view that the effort to protect financial consumers and markets from mis-selling due to incentives is so fundamental to modern society that no C-B analysis other than common sense and decency should be applied. We caution regulators not to be steered down this bear trap -ridden path. Read ***The arguments against Cost-Benefit Analysis*** <http://www.brighthubpm.com/project-planning/58627-arguments-against-the-cost-benefit-analysis/>

The APPENDIX hereto provides backup for the comments and observations we have made. The evidence is overwhelming ; the current incentive system is causing Canadians significant harm. We agree with the CSA: “ *The current mutual fund embedded trailing commission structure, which offers a 'one size fits all' approach, seems potentially misaligned with the current practice of providing services tailored to an investor's personal circumstances, expectations and preferences* ”.

We hope this Comment letter proves useful to the CSA in its deliberations .Reforms are needed now if a demographic fiasco is to be avoided. Do not hesitate to contact us if there are any questions regarding our submission. Permission is granted for public posting.

We are excited about the roundtable the CSA plans to hold with investors and industry participants in 2013. Our entire team will be glad to support this.

Sincerely,

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## **APPENDIX: Selected References and discussion**

The references listed below paint a clear picture. The takeaway message is that the mutual fund industry has evolved into a sales and marketing culture. Sales incentives like trailers support this culture. Any financial advice provided is incidental, undefined and ad hoc and unregulated. Fund industry lobbyists have been successful in blunting reforms in the \$850+ million Canadian mutual fund industry. This has however resulted in needed investor reforms being delayed or derailed. It is shocking that in the year 2012, Prospectuses are still required to be delivered AFTER the sale and most Canadian fund investors have no idea what their portfolio returns are. It is refreshing to see regulators now taking steps to address investor abuses and the looming demographic crisis.

There have been periodic attempts to break the embedded commission model and give DIY discount investors what they want: the stock-picking prowess of portfolio managers but without advice. In 2004, E-Trade Canada announced it would sell the F class funds of Invesco Trimark Investments and Elliott & Page. Self-directed investors cheered but both firms soon reversed themselves after the rest of the industry made known its deep displeasure. More recently Questrade Inc. unveiled its Mutual Fund Maximizer program, which rebates trailers on most big broker-sold funds. Not many fund companies offer F series, so Maximizer broadens the range of funds from which to choose. But again the fund industry took offence. Questrade revealed Sprott Asset Management will no longer let it rebate Sprott trailer commissions to Questrade clients. In July, a major bank-owned discount broker cut top performing Steadyhand funds out of its lineup because it does not pay trailers. This anti-investor behaviour is what you get from a pervasive sales culture.

If the industry was client-focussed, fund manufacturers would reduce price breakpoints, introduce D Series funds such as RBC has done, eliminate DSC money market funds and reduce fees. It seems odd that investor advocates, bloggers and personal finance journalists promote TD's low cost eFunds more than TD does. This is an industry that treats "advisers" better than customers. That's why one of our recommendations is to introduce competition via access to U.S. Mutual funds.

The commission-based system corrupts dealer and "advisers" Back in 2005, the MFDA said it was aware that a number of MFDA members had entered into referral arrangements with Portus, a controversial and troubled fund, regarding managed accounts involving BancNote Trust Series investments. It said "MFDA members in the affected jurisdictions must immediately cease referring clients to Portus during the period covered by the temporary order and any subsequent orders," the MFDA says. The regulator also directed dealer to "take appropriate steps" to determine if any of their Reps have entered into referral arrangements directly with Portus and if so, to cease such activity immediately. It reminded dealers and Reps that securities-related referrals cannot be entered into by Reps either directly or indirectly through another entity, such as an insurance agency or a personal service corporation, these sorts of referrals can only be made through an MFDA member. Over 20 % of Portus assets were acquired by referral arrangements that paid outsized sales commissions. A key fact about which there is clarity is that Portus paid exorbitant fees to advisors who referred their clients to Portus and provided them with sales incentives that would be banned if the investments their clients were making were in conventional mutual funds. It is also clear that the dealers/advisors who referred their clients to Portus did not look beyond the dollar signs and sales incentives in determining the

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suitability of the Portus investments for their clients. Nor did they seem to understand or appreciate the need for due diligence inquiries respecting the nature, structure and governance of these investments, or the nature and validity of the principal-protection arrangements. The arguments that the dealers/advisors were relying on Portus to do this points out serious weaknesses in the securities regulatory system.

According to the latest CFA Institute Global Market Sentiment Survey (2013) , financial firms have themselves to blame for the lack of public trust in the industry. The survey found that over half of the respondents outside of Canada (56%) believed that the lack of an ethical culture within financial firms was the biggest factor contributing to the current distrust of the financial industry. In Canada that number was slightly higher at 58%.According to the survey participants, one way to regain the public's trust is through the improved enforcement of existing laws and regulations. Globally, 24% of CFA members agreed with this approach. Of the CFA members surveyed in Canada, 27% felt this was one of the best ways to improve investor trust and market integrity. Source:

[http://www.cfainstitute.org/about/research/surveys/Pages/global\\_market\\_sentiment\\_survey\\_2013.aspx](http://www.cfainstitute.org/about/research/surveys/Pages/global_market_sentiment_survey_2013.aspx)

Mike Macdonald, a fee-only planner and portfolio consultant with Burlington, Ont.-based Weigh House Investor Services notes " The litmus test is clearly 'Can advisors push this?,' followed by 'Will Advisors feel incented?' If the answer to both is 'Yes,' a new fund is born."Trailers are entrenched in the industry DNA. Weigh House also took a critical view of permitting financial advisers to incorporate <http://www.finance.alberta.ca/publications/other/2011-0215-warren-mackenzie.pdf> as did we. The industry has chosen to bend the playing field in favour of distributors and “advisers” to the detriment of retail clients. It's time that regulators level the playing field.

### **Fund Industry Overview**

**How to Lose Market Share** [ a warning message to the complacent Canadian mutual fund industry]  
<http://www.investmentexecutive.com/-/comment-how-to-lose-market-share?redirect=%2Fsearch>

### **90% SALES 10% ADVICE :A SNAPSHOT OF THE FINANCIAL PLANNING INDUSTRY**

<http://www.industrysupernetwork.com/wp-content/uploads/2011/10/A-snapshot-of-the-financialplanning-industry-110930-1010version.pdf> "The facts set forth in the report support the position long held by ISN that ongoing commissions and asset-based fees for advice enable planners and dealer groups to earn ‘passive’ income at the expense of consumers and should be banned, along with all other forms of conflicted remuneration. If ongoing asset-based fees are permitted to continue, credible reform requires that these fees be subject to a regular ‘opt-in’ mechanism. The ASIC [ Australian Securities Commission] report has pulled back the curtain to reveal the extent to which the structure of the financial planning industry impedes planners from being able to act in the best interests of their client. The Future of Financial Advice reforms are essential to restructure this industry to serve the interests of clients, who are relying on advisers to help them save for retirement, build wealth, and otherwise manage their financial lives. However, the financial planning industry has stridently opposed the key aspects of reform legislation that would clean up their industry. The ASIC report makes this opposition easy to understand: this is an industry built around conflicted remuneration and passive

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income charged to millions of unwary clients (often from their compulsory super) who receive no ongoing services. "

### **Investing industry is a drag on returns- by design**

<http://www.theglobeandmail.com/globe-investor/investment-ideas/strategy-lab/growth-investing/why-mutual-funds-hurt-your-returns/article4619712/> ".One simple example of that drag is the fees charged by actively- managed mutual funds. Those levies take a big bite out of your returns. [Andrew Hallam](#), the millionaire teacher and a fellow [Strategy Lab](#) contributor, has written [compelling articles](#) demonstrating that actively-managed funds underperform a broad stock market index. He's right." G&M Oct 18, 2012. ,Pg B16

**Conflict -of- interest part of DNA** In "[Conflicts of Interest and Competition in the Mutual Fund Industry](#)," Ajay Khorana (Georgia Institute of Technology) and Henri Servaes (London Business School) examine how conflicts-of - interest in the U.S. mutual-fund industry affect competition and investor behaviour (their database covered the period 1979-1998). Overall, their paper "highlights a number of conflicts between fund families and investors," say the authors. For example, they found "no evidence that investors derive any benefit" from annual fees for marketing and distribution (12b-1 fees in the U.S). Furthermore, "fund families generally want to maximize assets under management ... and the resulting management fees," an objective at odds with investors' "desire for high risk-adjusted performance at low cost."

### **The Genesis of DSC Mutual Funds | WhereDoesAllMyMoneyGo.com**

<http://wheredoesallmymoneygo.com/the-genesis-of-dsc-mutual-funds/> Shows how the trailer was born.

**According to a [new report](#)** from PriceMetrix, released August 15<sup>th</sup> , 2012 advisors who aggressively move a significant portion of their assets under management into fee-based accounts quickly benefit from an increase in assets, a higher return on assets and ultimately greater revenues.[ Mutual fund wraps are a good example of a wrap account]

### **Impact of Fees on Investor Returns**

#### **Research: *The \$25 billion annual mutual fund rip-off***

[http://cupe.ca/pensions/The\\_25\\_billion\\_annua](http://cupe.ca/pensions/The_25_billion_annua)

A comprehensive study by Canadian pension fund expert Keith Ambachtsheer has found that defined benefit pension plans in Canada achieved annual average returns at least 3.8% higher than mutual funds with comparable investments. Defined Benefit pension funds outperformed the market by 1.23% per year, while mutual funds had average returns that were 2.6% below the market during the 1996 to 2004 period. Returns for most mutual investors were even less than this, as a result of sales fees and consistently poor selection of mutual funds by misinformed investors: buying high and selling low. This means that those with savings in mutual funds lost a total of about \$25 billion a year from the higher management fees and lower returns compared to workplace pension funds. Higher management fees are responsible for about \$15 billion of this.

**How do Investing Costs Hurt Returns? Let me Count the (19) ways-** John Heinzl G&M  
<http://www.theglobeandmail.com/globe-investor/investor-education/how-do-investing-costs-hurt-returns-let-us-count-the-ways/article4389453/> Examples include trading commissions, embedded bond commissions, embedded IPO commissions, MER's, performance bonuses, FEL's, Mutual fund Switch fees, DSC early redemption penalties, RRSP administration fees, CEF embedded fees, Asset-based fees, Layered fees, Fee for Service, Tracking fees, Account transfer fees, Liquidation costs ( occurs when new "adviser" comes on the scene), Tax on mutual fund capital gains distributions, Price spreads on illiquid stocks, Taxes resulting from actions taken by high turnover funds AND our additions, mutual fund trailing commissions, inactivity fees and currency conversion fees. Heinzl adds " *Those that are aware of fees often believe that higher costs are the price for higher returns, when in fact, keeping costs low is the key to successful investing*". [ Fees are the silent killers of investment returns. Many investors are only dimly aware that fees even exist, but over the long term, fees can cause serious damage to a portfolio. Consider that \$100,000 invested at 8 per cent for 25 years will grow to \$684,847. Take off just 2 per cent in fees and that same \$100,000 will grow to \$429,187 - a difference of \$255,660.]

**Morningstar research :How Expense Ratios and Star Ratings Predict Success** If there's anything in the whole world of mutual funds that you can take to the bank, it's that expense ratios help you make a better [ purchase] decision. In every single time period and data point tested, low-cost funds beat high-cost funds. To see the results, click [here](http://factualfin.com/blog/blog2.php/how-expense-ratios-and-star-ratings-pred). <http://factualfin.com/blog/blog2.php/how-expense-ratios-and-star-ratings-pred> In other words, Fees Count!

**Morningstar Research report :Global Fund Investor Experience 2011**  
<http://corporate.morningstar.com/us/documents/ResearchPapers/GlobalFundInvestorExperience2011.pdf> "...The story is less happy with Regulation and Taxation. Canada has steep investment taxes that are applied to fund management fees. Although Canada offers fund investors a tax break for capital gains and dividend income, their overall tax bill remains high. Additionally, taxes are levied on the service of fund management. This increases fund expenses. With regulation, Canada restricts competition by not permitting foreign-domiciled funds to register for sale in Canada. Nor does it offer fund investors the protection of a board of directors. **Canada fails for Fees and Expenses. Among the 22 countries in this survey, Canada has the highest annual expense ratios for equity funds, the third highest for bond funds, and tied for the highest for money-market funds. These costs cannot be explained by pointing to unique features of the Canadian fund market. Canada's method for computing fund expenses is the global standard, and its distribution model of financial advisors selling and servicing no-load funds is widely shared (although not by its southern neighbor, the United States).**"

**The Tyranny of Compounding Fees: Are Mutual Funds Bleeding Retirement Accounts Dry?**  
<http://www.fpanet.org/journal/currentissue/tableofcontents/thetyrannyofcompoundingfees/> Over the past few years fixed rate Administration Fee has become popular. While the fixed rate Administration Fee can bring some stability and predictability to the level of a mutual fund's operating expenses, it can also effectively prevent mutual fund expenses from declining as a percentage of assets as the fund

grows. It also greatly reduces disclosure of several cost elements. More recently, we have seen requests for exemptions or amendments to require fund investors to share in any shortfalls ( but not upsides)

**Lessons from proprietary mutual fund returns - Yahoo! Finance Canada**

<http://ca.finance.yahoo.com/news/lessons-proprietary-mutual-fund-returns-195227448.html>

**Wrap mutual fund disappointment**

<http://www.fa-mag.com/news/wrap-mutual-fund-disappointment-12154.html>

**Report shows Canadians getting hosed** A 21- page FAIR Canada Report <http://faircanada.ca/top-news/fair-canada-issues-report-on-money-market-funds-canadians-losing-out-on-300-500-million/>

found that Canadians hold \$56 billion in money market funds (MMF) earning almost nothing. In the six months to year end 2009, the average Canadian MMF earned just 0.02% after costs, before the impact of inflation and taxes. The average return for the most recent 30 and 60 day periods was 0%. Even worse, fully one quarter of all Canadian money market funds (mostly smaller segregated funds) lost money in the three or six months to December 31, 2009, and continue to lose money. Again, we find strong evidence that advisors aren't paying much attention to the needs of clients. Incredibly, money market funds carry trailing commissions of 0.25% and some are sold on a DSC basis!; typically, Equity funds sold on a front-end load and no-load basis carry trailing commissions of around 1%, Fixed income funds carry trailing commissions of around 0.50% .

**Wrap Account Ripoff ( Forbes.com ):** "In 2007 Josephine DesParte, an 88-year-old Chicago widow, had \$8 million tucked into an account at William Blair & Co. One-quarter of it was in municipal bond funds and cash and the rest in three stocks dear to her heart: Together the securities were generating more than \$100,000 in annual dividend and interest income. DesParte's coupon-clipping strategy made good sense for the widow, but she claims the inactivity made the commission-based account a dud for William Blair. In October 2007 brokers Brian L. Kasal and William H. Ross persuaded DesParte to begin selling her stocks and many of her bonds and to diversify into a number of blue chips. They also moved her into a wrap account, which, DesParte would later claim, gave William Blair the advantage of shaving off 1.5% of her assets a year, or \$120,000, in annual fees. The brokers' moves further saddled her with a \$322,000 capital gains tax bill for 2007, DesParte claimed. DesParte filed a \$2 million claim with the Financial Industry Regulatory Authority seeking compensation for wrongful investment losses and taxes. She was awarded \$1.1 million in November 2009 .

<http://www.forbes.com/forbes/2010/0412/investing-brokerage-commission-retirement-finra-ripping-you-off.html?boxes=Homepagetmagazines> " Needless to say, wrap accounts and managed accounts are on the upswing in Canada and wreaking havoc with portfolio performance.

**Research: *Why Does the Law of One Price Fail? An Experiment on Index Mutual Funds***

<http://www.ncbi.nlm.nih.gov/pmc/articles/PMC2872995> ABSTRACT : We conduct an experiment to evaluate why individuals invest in high-fee index funds. In our experiments, subjects allocate \$10,000 across four S&P 500 index funds and are rewarded for their portfolio's subsequent return. Subjects overwhelmingly fail to minimize fees. We can reject the hypothesis that subjects buy high-fee index funds because of bundled non-portfolio services. Search costs for fees matter, but even when we

eliminate these costs, fees are not minimized. Instead, subjects place high weight on annualized returns since inception. Fees paid decrease with financial literacy. Interestingly, subjects who choose high-fee funds sense they are making a mistake. [ The composition of their subject pool , college staff/MBA students made it more likely that they would find support for rational theories; given the dismal results it is thus no surprise that ordinary Canadians have trouble figuring out fund fees]

### **High Fees Destroy Bond Fund Performance | Morningstar**

<http://www.morningstar.co.uk/uk/news/95449/high-fees-destroy-bond-fund-performance.aspx>

**Trailer commissions are BIG \$\$'s** <http://www.thestar.com/business/article/846861--daw-industry-defends-mutual-fund-trailer-fees> According to a August 12<sup>th</sup> 2010 article by the Toronto Star's James Daw , *Industry defends mutual fund trailer fees* , a lot of money is at stake. He quotes Carlos Cardone, senior consultant with research house Investor Economics who says about \$2 billion was deducted from Canadians' mutual fund assets in 2009 to pay advisers what are called trailer commissions. That compares with about \$9.5 billion in the U.S., with ten times the population. The Canadian figure excludes what banks embed in their funds to pay sales and advisory staff. Bank funds hold roughly 30 % of total mutual fund assets in Canada. According to the CSA Consultation " A significant portion of the management fees earned by most Canadian mutual fund manufacturers on the mutual funds they manage is used to pay an ongoing commission to dealer firms. This payment was originally intended to compensate dealer firms for the ongoing services their advisors provide to investors after the mutual fund purchase, including investment advice. This is generally referred to as the "trailer fee" or "trailing commission"...Trailing commissions are usually paid by mutual fund manufacturers to dealer firms quarterly for as long as their clients hold investments in the manufacturers' mutual funds. Each dealer firm then pays out a portion of those trailing commissions to its advisors according to the firm's own compensation grid. Generally, under this compensation grid, the more commission or fee revenue the advisor generates for the firm, the greater the portion of that revenue the advisor gets to keep." There is ZERO connection to the amount or quality of advice provided or any measures of client satisfaction.

### **How much do actively-managed mutual funds cost investors?**

<http://independentinvestor.info/content/view/full/961/236/1/0/> "When you add up the numbers for MER, taxes and load fees you come up with the following (what is sometimes called the croupier's take; see [Davis 2009 Reveal the true cost of the croupier's take](#) doc.1825). In the US -the MER, impact and load costs add up to 3.87% of fund investments. In Canada - the comparable number is 5.13%. Therefore, the typical US and Canadian equity funds needs to outperform their index benchmarks by almost 4% and by more than 5%, respectively, in the two countries before its investors do better than the market as a whole. This is a major challenge, and the odds of any active fund manager overcoming these types of numbers are very poor. And remember these numbers do not take into account expense categories 2 (non-MER MER expenses), 3 (non-traditional management fees), 4 (mutual fund shenanigans) and 7 (risk premium) in our list because we have not been able to quantify them but which are nevertheless very real expenses."

### **How much are you paying for U.S. dollars?**

[http://canadiancouchpotato.com/2012/12/17/how-much-are-you-paying-for-us-dollars/?utm\\_source=rss&utm\\_medium=rss&utm\\_campaign=how-much-are-you-paying-for-us-dollars](http://canadiancouchpotato.com/2012/12/17/how-much-are-you-paying-for-us-dollars/?utm_source=rss&utm_medium=rss&utm_campaign=how-much-are-you-paying-for-us-dollars)

"Currency conversion remains one of the biggest rip-offs in banking and investing. It's made worse by the lack of transparency: if you call your discount brokerage they'll quote their current rates, but it's still hard to calculate the actual cost of your transaction. Don't expect your brokerage to help with the math."

### **Influence of "Advisers"**

**Research: *What is the Impact of Financial Advisors on Retirement Portfolio Choices and Outcomes?*** <http://www.nber.org/programs/ag/trc/NB10-05%20Chalmers,%20Reuter%20FINAL-revised.pdf>

**Trailer Commissions – do they skew recommendations?** Ken Kivenko , Kenmar Associates  
Unpublished, September 2012 Available upon request by contacting [kenkiv@sympatico.ca](mailto:kenkiv@sympatico.ca) “ ..The mutual fund sellers may employ the tactic of selling 10% of your mutual funds each year and then reinvesting in other funds to generate new commissions which are greater than the trailer commissions fees they would receive if you held your funds. ..Fund companies usually watch every nickle they spend, but in the case of trailers they just send out the cheques without regard to the quality of service, frequency of service or even if the advisory service is provided at all. Fund manufacturers rarely, if ever, follow-up with investors to determine the level of satisfaction with the so-called trailer services provided.... ” It appears to us that "advisers" only seem to make Sell recommendations when the DSC period ends.To be fair, we are aware of cases where some advisers have constrained panic selling.What we have rarely seen is an adviser recommending the sale of a fund to pay down debt or switch to a lower fee, better performing fund with lower trailers.That's what we call skewed advice- not unsuitable ,but clearly not in the client's best interests.[ The CSA defines the term “advisor” as a plain language term that is used in the same way that mutual fund industry participants and members of the public commonly use this term to refer to a mutual fund salesperson. The CSA asserts that the term “advisor” is not indicative of a mutual fund salesperson’s category of registration with Canadian securities regulators. Mutual fund salespersons that are registered with Canadian securities regulators to trade in mutual fund securities are, in most cases, registered as dealing Representatives of mutual fund dealers or investment dealers. Yet, by allowing use of this term ,the CSA is complicit in perpetuating the myth that registered Reps are fiduciaries. We urge the CSA to consider the fact that the use of misleading titles adds to investor risks. ]

**Research : *Investor behaviour and beliefs: Advisor relationships and investor decision-making study***  
OSC Investor Education Fund <http://www.getsmarteraboutmoney.ca/en/research/Our-research/Documents/2012%20IEF%20Adviser%20relationships%20and%20investor%20decision-making%20study%20FINAL.pdf> “ ..In summary, advisors are the key influence in investor decision-making. Investors rely upon their advisor for planning and asset mix advice, as well as advice on what specific investments to buy. Other sources of information are secondary to the advisor’s opinion. Investors trust their advisor to provide advice that benefits the client first. This trust is underpinned by a belief that their advisor has a legal responsibility to ‘put the client’s best interest first’. With this as a foundation of investor belief, investors find little reason to be concerned about fees, and perhaps as a result, fewer than half of advisors disclose what they are paid..”. Another troublesome finding is that disclosure of trailing commissions declines as the age of the investor increases. Some 40% of 20-39 year olds agree that trailing commissions were disclosed versus 24% for age 40-59 and just 18% for

those age 60+. This suggests to us that a seniors vulnerability issue has developed.

### Adviser Risk

<https://docs.google.com/viewer?a=v&pid=forums&srcid=MDOyNjM4MzIyMTkzMjc2ODgyNDABMTQxNTYxNzExMTMwMjcyMzE2NzEBV2IUMEYtb1ZrejBKATQBAXYy> Trailer commissions are embedded in the management fee rather than shown separately. Many retail investors mistakenly believe there is no cost to buying or owning a mutual fund. They don't grasp the significance of distribution costs on Rep recommendations. Dealer Representatives aren't required to disclose all forms of their compensation, such as trailer commissions, that they earn from clients' fund investments. If mutual fund costs aren't mentioned to clients, they don't become a factor in a client's decision-making. This creates a risk for unsuspecting clients. [ Costs deter only one of six investors from buying, according to an Investor Education Fund survey which is a major financial competency problem in itself.]

**Do advisors really help reduce the buy high, sell low trap or do they contribute to it?** In their study, "[Assessing the Costs and Benefits of Brokers in the Mutual Fund Industry](#)," Daniel Bergstresser (Harvard Business School), John Chalmers (University of Oregon), and Peter Tufano (Harvard Business School) analyze a database of U.S. mutual funds from 1996 to 2004. Their objective was to compare the performance of investors who bought funds through broker-dealers to investors who purchased funds directly. They found that investors with broker-sold mutual funds experienced "lower risk-adjusted returns, even before subtracting distribution costs." They also found that investors purchasing broker-sold funds were directed into funds with "substantially higher fees" and failed to show superior asset allocation. And as for helping investors avoid behavioral biases, "regrettably, the advisers generally demonstrated all the same biases that the rest of us have." Even without this study, one only had to look at how advisors overemphasized technology funds in the late 1990s and how many advisors are overemphasizing energy, gold, and foreign funds today.

### Trust and the Investment Adviser Industry: Congress' Failure to Realize FINRA's Potential to Restore Investor Confidence

<http://erepository.law.shu.edu/cgi/viewcontent.cgi?article=1002&context=shlj>

**Research shows commissioned advisers add trouble not returns** According to [Do financial advisers improve portfolio performance?](#), a study of German investors at Vox by university professors Andreas Hackethal, Michalis Haliassos and Tullio Jappelli. says they don't. The reason is the old bugaboo - costs and fees. Advisors add value but ... *"Even if advisors add value to the account, they collect more in fees and commissions than they contribute."* Apparently the authors found that richer, older people tend to use advisors more which accounts for a preliminary gross conclusion that *"Investors who delegate portfolio management to a financial advisor achieve on average greater returns, lower risk, lower probabilities of losses and of substantial losses, and greater diversification through investments in mutual funds."* They note that the financial industry would love to grab that statement for publicity. However, the net truth is completely opposite: *"Once we control for different characteristics of investors using financial advisors, we discover that **advisors actually tend to lower returns, raise portfolio risk, increase the probabilities of losses, and increase trading frequency and portfolio turnover relative to what account owners of given characteristics tend to achieve on their own.**"*

**In Whose responsibility is suitability?** Lawyer Harold Geller observed: " *Clearly, the advisor and the dealer jointly bear the responsibility to recommend an appropriate match between the product and the client. Despite widespread investment industry misunderstanding to the contrary, suitability analysis is never the responsibility of the client. IIROC Rule 1300.1(q) requires that both dealer and advisor, "when recommending to a customer the purchase, sale, exchange or holding of any security, shall use due diligence to ensure that the recommendation is suitable for such customer."* MFDA Rule 2.2.1 is similar. Nowhere is this obligation for ensuring suitability imposed on the client - even in the case of unsolicited orders." Source: IE , May 2012 [ Issues related to suitability of investments constitute the lion's share of investor complaints investigated by the Ombudsman for Banking Services and Investments-2011 statistics show 224 of 453 (49.54 %) complaints were about suitability issues. Investors who have lost money on miss-sold transactions ,ones that failed to match their investment profile or goals, will seek restitution for losses claiming that the security or mutual fund was unsuitable. The vast majority of complaints to the OBSI concern securities and mutual funds, but also cover high commission products like Segregated funds, Principal Protected Notes and Scholarship trusts. About 35 % of investment complaints made to OBSI result in complainant compensation,meaning that over one third of investor complaints dealers have rejected, have been overturned by OBSI, a rate suggesting that the dealer complaint handling process is not robust/fair. .

**Financial Abuse** - ( this insightful exposition was written several years ago before the IDA morphed into IIROC ). Author Andrew Teasdale is an expert on suitability, KYC and portfolio construction) [http://moneymanagedproperly.com/new\\_folder/rights%20and%20abuse/financial%20abuse.htm](http://moneymanagedproperly.com/new_folder/rights%20and%20abuse/financial%20abuse.htm) “**...Trailer fees:** Trailer fees are annual fees paid by a mutual fund company to an investment advisor for recommending the mutual fund. The investor does not need to be told about this even though the money is paid from the investor’s own funds. Likewise the advisor has no obligation to do anything for the client to earn these fees. Trailer fees and other referral type fees are an abuse of the client -advisor relationship and, unless these fees are disclosed and used to offset valid and identifiable services performed by the advisor, they increase costs and are detrimental to an individual’s financial position. The greed of the industry has seriously affected the ability of mutual funds to meet the objectives and needs of the individual. **Indeed, the benefits of one of the most efficient investment vehicles ever invented have been submerged under the self interests and costs of an industry that has lost sight of its reason for being....**” [ The fact that trailer commissions as a percentage of "adviser" income has risen since 1996 was not known to retail investors .The lack of disclosure added to investor risks and may explain the apparent increase of leveraging and the rapid rise of wrap accounts]

**Research: *Legal liabilities of Financial Advisors in Canada***

<http://www.canadianfundwatch.com/2012/10/legal-liabilities-of-financial-advisors.html>

**Financial Advisors Encourage Bad Behavior**

<http://www.forbes.com/sites/rickferri/2012/03/30/financial-advisors-encourage-bad-behavior/>

***The Market for Financial Advice: An Audit Study*** This working paper by Sendhil Mullainathan (Harvard), Markus Noeth (University of Hamburg), and Antoinette Schoar (MIT), was recently published by the National Bureau of Economic Research ([NBER](http://www.nber.org/)), a private, non-profit, non-partisan research organization. Most individual [investors consult a financial advisor](#) before purchasing

investments. Given the central role of advisors in the investment process, Mullainathan, Noeth and Schoar tested whether financial advice serves to de-bias individual investors and thus correct mistakes they might make without these inputs, or whether advisors encourage the same bad behavior. The study defines ‘good advice’ as recommendations that move investors toward a low-cost, diversified index fund approach, which [textbook analyses](#) on mutual fund investing suggests. Overall, their findings suggest that the market for financial advice does not alter individual investor biases, and if anything may exaggerate existing biases. They also found that advisor self-interest plays an important role in generating recommendations that are not in the best interest of the clients. They are unwilling to lean against these biases even when they know they exist because not doing so helps them further their own economic interest.

### **Research: *Mutual Fund Investors: Sharp Enough?***

Who are mutual fund investors? The answer is critical to regulatory policy. The mutual fund industry portrays fund investors as diligent, fairly sophisticated, and guided by professional financial advisors. The SEC paints a more cautious portrait of fund investors, though touts improved disclosure by the fund industry as a sufficient antidote. However, an extensive academic literature finds that fund investors are unaware of the basics of their funds, pay insufficient attention to fund costs, and chase past performance despite little evidence that high past fund returns predict future returns. These findings suggest that policymakers should rethink current regulatory policy. Disclosure may not be enough. <http://ideas.repec.org/a/ris/jofitr/0948.html>

### **Fund Fact sheets littered with weaknesses**

<http://www.theglobeandmail.com/globe-investor/investment-ideas/fund-fact-sheets-littered-with-weaknesses/article625822/> In this piece respected fund analyst Dan Hallett discusses FF deficiencies re risk disclosure. We agree with Dan's observations and also add that we have for the past 4 years been pleading with regulators to spell out Rep/dealer conflicts-of-interest and locate fund fees disclosure ahead of performance on the Fund Facts form. Relocating cost information would give costs more prominence.

### **Investor Awareness Booklet**

Enhancing the Client-Financial Advisor Relationship (Presented by Onus Consulting Group)  
Evaluating Your Financial Advice While Gaining a Better Understanding of Canada's Retail Investment Industry

[http://www.onusconsultinggroup.com/uploaded\\_files/InvestorAwarenessBooklet.pdf](http://www.onusconsultinggroup.com/uploaded_files/InvestorAwarenessBooklet.pdf)

### **Research on Fund fees: *Out of Sight , Out of Mind: The Effects of Expenses on Mutual Fund Flows***

<http://faculty.haas.berkeley.edu/odean/papers%20current%20versions/Out%20of%20Signt.pdf> The more opaque the fees, the easier it is to bamboozle retail clients. The paper by Brad Barber, Terrance Odean and Lu Zheng concluded that :“..*We report evidence that mutual fund marketing does work. On average, any negative effect of expense fees on fund flows is more than offset when that money is spent on marketing; non-marketing expenses, however, reduce fund flows. Though [ front load] load fees are also spent on marketing, the positive effect of marketing on flows does not appear to be sufficient to offset investors growing awareness of and aversion to loads...*” While operating expenses ( including

Kenmar Associates  
The Voice of the retail Investor

*embedded trailers) constitute a steady drain on a fund's performance, the effect of that drain is masked by the considerable volatility in the returns on mutual funds...*" [ We've always found it curious that the fund manufacturer marketing materials and advertisements do not refer to the advice component of the mutual fund proposition. It is strange because IFIC gives advice such emphasis in their lobbying literature.]

**Risks to Customers from Financial Incentives** <http://www.fsa.gov.uk/static/pubs/guidance/gc12-11.pdf> [ UK FSA] This is an excellent document demonstrating how incentives distort advice. After extensive research the FSA found that:

- Most firms did not properly identify how their incentive schemes might encourage staff to mis-sell. This suggests they had not sufficiently thought about the risks to their customers or had turned a blind eye to them.
  - Many firms did not understand their own incentive schemes because they were so complex, making it harder to control them.
  - Firms did not have enough information about their incentive schemes to understand and manage the risks.
  - Most firms relied too much on routine monitoring, rather than risk-based monitoring, such as performing more checks on staff with high sales volumes.
  - Some firms had sales managers with a clear conflict- of- interest that was not properly managed.
  - Many firms had links to sales quality<sup>1</sup> built into their incentive schemes that were ineffective.
  - Some firms had not done enough to control the risk of potential mis-selling in face-to-face situations.
- Such results have caused the FSA to essentially ban commissions.

### **Macro Considerations**

#### **CFA Institute Integrity List: 50 Ways to Restore Trust in the Investment Industry**

[http://www.cfainstitute.org/about/vision/serve/Pages/integrity\\_list.aspx](http://www.cfainstitute.org/about/vision/serve/Pages/integrity_list.aspx) #3 Place the client's interests before your own ; #8 Strive for a conflict-free business model

#### **Protecting Seniors and Their Life Savings: Policies and Practices of Missouri's Investment Firms**

A specific policy that ensures account information for senior clients is maintained, regularly reviewed, and updated is a solid approach to avoiding unsuitable recommendations. This information is vital because as investors age, their investment time horizons, and objectives, risk tolerance, family's needs and tax status may change. Liquidity becomes a higher priority, and products that were once a sound investment may no longer be suitable if money is locked up in complicated products where liquidation is possible only after a substantial penalty is paid. These changes in investment needs and goals can be recognized in a timely manner through regular account maintenance and updating.

[http://www.sos.mo.gov/securities/MIPC/SecuritiesReport\\_ProtectingSeniorsLifeSavings.pdf](http://www.sos.mo.gov/securities/MIPC/SecuritiesReport_ProtectingSeniorsLifeSavings.pdf)

#### **The Changing State of Retirement in Canada – Fidelity ( Oct. ,2007)**

[http://m.twmg.net/state\\_of\\_retirement\\_cda.pdf](http://m.twmg.net/state_of_retirement_cda.pdf) A survey of more than 2200 households shows that

Canadians are on track to replace only 50% of their pre-retirement income. To maintain a comfortable lifestyle they may need as much as 80% of pre-retirement income. That's one reason that investing fees and expenses are so important.

**University of Toronto Research Report : *Fraudsters Take Aim at the Baby Boomers* ( May, 2007)**  
[http://www.utoronto.ca/difa/PDF/Research\\_Projects/DIFA2007](http://www.utoronto.ca/difa/PDF/Research_Projects/DIFA2007)

### **Why Don't Most Financial Planners Plan Finances?**

[A recent article <http://www.milliondollarjourney.com/why-don%E2%80%99t-most-financial-planners-plan-finances.htm>](http://www.milliondollarjourney.com/why-don%E2%80%99t-most-financial-planners-plan-finances.htm) on financial planning stated:" While many financial planners claim to do financial planning and provide holistic advice, very few actually provide comprehensive planning with written financial plans, as taught in the CFP courses. The issue is best highlighted by Alan Goldhar, Professor of Financial Planning at York University and Manager for the Ontario Public Trustee. The Public Trustee takes over the finances for people that are mentally unable to make financial decisions. They have taken over more than \$500 million in investments for 10,000 clients, most of which had a financial planner, broker or bank advisor. They interview the client and the family and then send in a team to obtain all financial documents. The shocking fact is that, of the 10,000 clients they took over, none had a financial plan! Not one!". For seniors, such a state of affairs is more than troubling.

### **Retirement brings new financial challenge**

<https://secure.globeadvisor.com/servlet/ArticleNews/story/gam/20121127/SRWEALTHMGMTQAMP AATL> The investor de-accumulation phase will have a major impact on the advice industry. Drawing down assets in retirement encompasses more than simply ensuring that clients have enough money to cover living expenses and such lifestyle choices as vacations and golf fees each year, but also that clients are not pulling so much out of retirement nest eggs that they are bumping into higher and higher tax brackets. Retirement income planning, covers just how much income people should draw from various sources: tax-deferred, tax-exempt and taxable income accounts. This is true financial planning and is significantly different from transaction based selling of mutual funds. The Regulatory and fund industry implication are self-evident. We're surprised there is so little debate about opening up a supplemental tranche of CPP as an obvious and elegant solution to most retirement concerns being discussed. Securities regulators are not qualified and ill suited to develop retirement incomes policies in Canada. Canadians at large are not willing allocators of capital. It's something they are forced into doing in the absence of alternatives. Many cost and behavioural finance concerns would be resolved with the CPP option. Flaherty came close to going this route at the PEI first ministers conference but caved to the insurance lobby and we got the stillborn PRPP instead. We stand with Keith Ambachtsheer and Malcolm Hamilton in support of an expanded CPP.

**Research: Top 10 Issues Facing the Canadian Asset Management Industry**

<http://www.pwc.com/ca/en/investment-management/publications/top-10-issues-facing-canadian-industry-2010-09-en.pdf>

Mutual fund companies today face the challenge of differentiating themselves in the industry. As a result, fund companies are increasingly looking to their business models to acquire and retain assets. To succeed, fund managers will not only need to develop a robust distribution model, but focus on delivering knowledgeable, quality advice. Indeed, the advice channel in Canada is gaining importance amongst investors, which could be attributed to the complexity of funds, especially given the myriad of offerings and providers that investors can choose from and the positive experiences when using an advisor. In addition to mutual funds, investors are faced with numerous investment choices like exchange-traded funds (ETFs), wrap accounts, principal-protected notes, segregated and hedge funds. To better understand these products and how they fit in their portfolio, investors are looking for trusted advisors.

**Harper Government Preparing Now for the Challenges of Canada's Aging Population**

<http://www.fin.gc.ca/n12/12-127-eng.asp> Securities regulators also need to prepare for demographic changes. That's why initiatives on Best interests and mutual fund sales commissions are so critical.

**The Changing State of Retirement in Canada – Fidelity ( Oct. ,2007)**

[http://m.twmg.net/state\\_of\\_retirement\\_cda.pdf](http://m.twmg.net/state_of_retirement_cda.pdf)

A survey of more than 2200 households shows that Canadians are on track to replace only 50% of their pre-retirement income. To maintain a comfortable lifestyle they may need as much as 80% of pre-retirement income. That's one reason that investing fees and expenses are so important. They can mean the difference between a happy retirement and a very stressful one.

**CPP ‘economies of scale’ make it a cheaper alternative to PRPPs**

<http://business.financialpost.com/2012/11/27/cpp-economies-of-scale-make-it-a-low-cost-alternative-to-prpps/>

“In the final report of the Ontario Expert Commission on Pensions, Professor Harry Authors notes: “I feel obliged to report that a significant number of submissions raised the possibility [of] an expanded or two-tier CPP. I was particularly struck by the fact that this idea was raised in different ways in briefs from stakeholders as disparate as the Canadian Federation of Independent Business and the Canadian Labour Congress.””

**Trailers an ethical issue**

*“One could think about this whole area of fiduciary responsibility by going back a few thousand years to the Bible which happens to mention that **“You shall not...place a stumbling block before the blind”** ...which could be interpreted at least from two perspectives:*

- 1. Don't take advantage of the ignorant/uninformed/"blind" client by selling her 'products' inappropriate or more generally giving anything but 'advice' which is best for the the client...i.e. acting in a fiduciary role...this is something that regulators should be able to address simply by requiring all retail financial advice relationship to be conducted in the clients' best interest (or as someone suggested on this thread) or explicitly stating that this not a fiduciary, but a sales relationship...*
- 2. Don't place the the advisor into a situation/structure/context where he (due to moral "blindness") might fall into the trap where sells the client the wrong product just because it's the only one available from his employer (e.g. in-house funds rather than low cost plain vanilla ETFs) or permitted by his*

*license (e.g. mutual fund salesman) or transaction/trailer based compensation structure driving undesirable behaviour...(i.e. fee-only compensation is better and fee for service might be even better (though while lawyers are fiduciaries, they might still not be acting in the client's )*  
*So one could argue that the answer to superior outcome for the client is not just "fiduciary" but also related to "structure" (business model) of the advisor...better regulation could also help in the area of defining what constitutes advice (selecting appropriate investment vehicles is but a small part of the advice/services menu that a real advisor provides...regulators could also specify minimum standards for education/training of advisers...these could all go a long way to improve the current Canadian situation, which is still decades (as indicated by Andrew) behind the UK and other developed countries in consumer financial protection" - thanks to Peter Benedek*

### **UK Regulator taking action**

British regulators have launched a new initiative designed to eradicate financial industry sales incentives that may end up hurting clients. They have announced that they intend to put an end to mis-selling by financial firms caused by distorting sales incentives. The Financial Services Authority aims to address poorly designed incentive schemes that can result in customers being sold products they do not need, while boosting the earnings of the sales rep. The FSA has found that most incentive schemes that were looked at are likely to drive mis-selling, and this risk is not being properly managed. The Proposals can be found at [http://www.fsa.gov.uk/library/policy/guidance\\_consultations/2012/1211](http://www.fsa.gov.uk/library/policy/guidance_consultations/2012/1211) In Canada, sales commissions, trailers, commission grids, sales contests, bonuses, referral fees, and God knows what else is used to encourage "advisers" to sell more, often at the expense of the client's best interests. Disclosure of conflicts-of-interests is a meek and ineffective way to address the core issue.

cc

British Columbia Securities Commission  
Alberta Securities Commission  
Saskatchewan Financial Services Commission  
Manitoba Securities Commission  
Ontario Securities Commission  
Autorité des marchés financiers  
New Brunswick Securities Commission  
Superintendent of Securities, Prince Edward Island  
Nova Scotia Securities Commission  
Securities Commission of Newfoundland and Labrador  
Superintendent of Securities, Yukon Territory  
Superintendent of Securities, Northwest Territories  
[Superintendent of Securities, Nunavut](#)