SIPA Sentinel

September 2004

SIPA has a mission:

- **to aid public awareness of how the investment industry operates;**
- **to provide guidance to those who have a complaint about investments with a bank, broker, financial advisor, or other seller of financial products;**
- **and to pursue improvement of industry regulation and enforcement.**

Small Investor Protection Association - A voice for the small investor

Welcome new members!

You should receive your membership card and your User Name and Password to enable you to access the Member's Pages of SIPA's website at www.sipa.to.

SIPA Sentinel

From time to time SIPA will be including articles that offer opinions on subjects related to investing and the regulatory system. These are meant to help increase investor awareness, and SIPA may not share these opinions.

CARP/SIPA Report on Mutual Funds

SIPA members are invited to attend a media conference Tuesday, September 28, 2004, 11:15 a.m., at CARP - 27 Queen Street E. (corner Victoria) – Suite 1304, Toronto. Special guest: The Hon. Tony Ianno, Federal Minister for Families & Caregivers, Responsible for Seniors

CARP in partnership with SIPA will present Minister Ianno the Report & recommendations to enhance investor protection.

Since November 2003, Ken Kivenko, Robert Kyle and Stan Buell have worked with Judy Cutler and Bill Gleberzon of CARP to produce this Mutual Fund Report which makes recommendations for improved investor protection.

I urge members in Toronto area to attend. You will have the opportunity of speaking with other SIPA members, CARP representatives and the media. This is an important event.

I will be available to speak with you, and look forward to meeting with members.

Five Year Review of Securities Act

In this issue a SIPA webpage is included on the Standing Committee review of the Final Report of the Five Year Review Committee. Hansard Reporting & Interpretation Services provides records of submissions for August 18th at webpage:
http://www.ontla.on.ca/hansard/committee_debates/38_parl/session1/finance/F024.htm
And for August 19th at web page:
http://www.ontla.on.ca/hansard/committee_debates/38_parl/session1/finance/F025.htm
Copies of written and oral submissions are also available on Robert Kyle's website at:
http://regulators.itgo.com/

All in the family

The headline **"Failed Trader bilked his own family"** in the Toronto Star begs attention. James Daw writes about a failed foreign exchange trader who pleaded guilty to defrauding 30 individuals including his father and uncle, cousins, members of his wife's family, close friends and colleagues.

The trader encouraged investors to borrow money to invest in guaranteed investment certificates guaranteed by International Deposit Insurance Corporation, which does not exist.

Some victims told the court they lost their entire life savings, along with their mental health and relationships with other family members.

Victims of loss due to breach of trust lose much more than money. When family members are involved, the feeling of betrayal and the general loss of trust in others it is so much worse.

The following is from SIPA Events on the SIPA website and is reproduced for the benefit of those without computers and those who do not check our website on a regular basis. For those who receive the e-mail edition there are links to SIPA's website and the submissions made to the Standing Committee as well as those made to the Five Year Review Committee.

August 18, 2004 - SIPA Inc. Submission to Standing Committee on Finance and Economic Affairs

PUBLIC HEARINGS ON THE FIVE YEAR REVIEW COMMITTEE FINAL REPORT: REVIEWING THE SECURITIES ACT (ONTARIO)

The Standing Committee on Finance and Economic Affairs will meet pursuant to section 143.12(5) of the Securities Act to conduct a review of the Final Report of the Five Year Review Committee, and specifically the Report's priority recommendations, including:

- Securities regulation in Canada and a single regulator system; and
- The appropriate structure for the adjudicative tribunal role of the Ontario Securities Commission.

Hearings are scheduled to be held in Toronto on August 18, 19, 23 and 24 as required.

Interested people who wish to be considered to make an oral presentation should contact the Committee Clerk by 5:00 p.m. on Wednesday, August 11, 2004. Those who do not wish to make an oral presentation but who are interested in commenting on this issue may send written submissions to the Committee Clerk at the address below by 5:00 p.m. on Tuesday, August 24, 2004.

Stan Buell, president of SIPA, was out of province and unable to make an oral presentation. A written submission to the Standing Committee was submitted on August 11, 2004 and is available on the SIPA website. Several members of SIPA were scheduled to make oral presentations and some made written presentations. In 2000 SIPA had made a written submission to Mr. Purdy Crawford, chair of the Five Year Review Committee.

Are Income Trusts for You – Can you trust the income?

Many of our members have been looking for secure investments to try to avoid the losses that many have experienced. Over the last several years many investors have turned to income trusts. Investors often mistakenly believe that these trusts are guaranteeing a rate of return that appears very attractive compared to current G.I.C. and bond rates. The following article should help you to better understand the risks of investing in unit trusts.

Distributions dwindle at some income trusts

Unit prices tumble as earnings squeezed

Oil-sector spinoffs still thrive on higher prices

Non-energy income trusts are disappointing investors, with two more cutting or suspending their cash distributions to unitholders this week, causing a plunge in the value.

Specialty Foods Group income fund, which owns 56 per cent of ham, bacon and luncheon-meat processor Specialty Foods Group, saw the value of its units plunge yesterday — initially by more than 43 per cent — after it said Thursday that it was temporarily suspending distributions. After a conference call, Specialty's decline eased to 28 per cent, off $1.33 to $3.37.

Chief executive Thomas Davis wouldn't speculate about when the 5.3-cent distributions would resume and noted the fund had been distributing more than it was earning.

"We've decided to be conservative and, by cutting the dividend temporarily, expect to fairly quickly get cash distributions back into balance with earnings and to replenish the working capital that we've paid out of distributions this year," Davis said.

Units in the General Donlee income fund dropped more than 28 per cent, or $1.15, to $2.85. The fund had announced Thursday after markets closed that it was reducing distributions for the second time this year.

The fund derives its cash flow from precision machinery maker General Donlee Ltd.

The news and market value drops followed moves by other non-energy income trusts in recent months that have cut or suspended the cash payments — dividend-like payouts that attract investors to trusts in the first place. Trusts benefit from special tax treatment and are set up to pay out their earnings to unitholders through regular distributions.

In August, British Columbia vegetable distributor Hot House Growers income fund suspended its distributions due to an "unprecedented" drop in tomato prices.

The price of its units fell from almost $12 to the $7 range, where they have stayed for three weeks. Yesterday, they closed at $7.20, down 20 cents.

Trusts spun out of energy companies, the original format of the investment vehicle created in the 1980s, have been more reliable lately, but that's only because the energy cycle has been peaking recently, according to Gordon Tait, manager of royalty and income trust research at BMO Nesbitt Burns in Calgary.

"The oil and gas price cycle has been good lately, but it isn't always," Tait said. "In 1998, oil and gas trusts were absolutely miserable."

"Trusts are really high-yield equities, and every part of the equity universe comes with its own risks and opportunities, and it's no different for trusts," Tait said.

Reprinted from the Canadian Press

The following article by Larry Elford provides a former investment advisor's comments on mutual funds and profit motivation for investment advisors. Larry is in Alberta and is recently retired from twenty years in the investment industry as a registered representative mostly at a bank owned brokerage. Larry wrote columns for the Lethbridge Reporter on a regular basis.

Mutual funds and profit motivators

...how your investment advisor's personal compensation may have clouded the "professional advice" to you the client...

By Larry Elford

Larry Elford
Investment Advisor

When you deal with a firm and an advisor that promises professional investment advice that is in the best interests of the client…………….is this what you actually get, or are you the victim of some puffy advertising? You be the judge.

Prior to 1987, investment commissions were regulated, and non-negotiable. Life was good if you were an advisor, although we called ourselves, "stockbroker's", back then.

Clients who wished to purchase a mutual fund were required to pay whatever the prospectus called for. Templeton purchasers paid a 9% commission to buy the fund back then.

Then came deregulation and the market crash of 1987. Things changed. The company took away my business cards calling me a stockbroker, and gave me cards which referred to my title as one of, "investment advisor'.

No regard to the fact that "investment advisor" is a registered title with Securities Act guidelines and requirements that virtually none of us met, nor today do most company advisors meet. It was deemed to be a "more acceptable" title to refer to us by, than that of "stockbroker" after the crash. People were afraid of the word, "stock", after the crash.

Fast forward to 2004. Commissions have been deregulated for a time period coming up upon nearly two decades. The Internet has allowed people to buy investments faster and cheaper. Clients are more sophisticated, better informed, and have access to information in their homes that was unheard of in 1987. (Internet, CNN, CNBC, exchange quotes, business news)

Some advisors have grown and changed with the times, morphing from investment salesperson to investment advisor. However some have tried to play in both venues, that of pretending to be a professional advisor to the client, while actually acting the role of a commission product salesperson. The bulk of industry compensation schemes are still largely compensation incentive based.

Case in point. Have you ever, in the last twenty years seen one of the large, bank owned investment dealers state publicly that commissions are deregulated, and that you can buy your mutual funds without sales cost? No you have not. (I am willing to pay $100 reward for each example you can show to prove me wrong) Why? Because after twenty years in the business, I am fully aware of the fact that offering mutual funds without sales charge was a topic banned from discussion at the large firms. More than one firm has given me this rule either verbally or in writing. I am currently in litigation with one of the firms I worked for that forbid the airing of commission free or even commission reduced mutual funds. They are so far denying ever acting in this manner, (as it violates their code of ethics) however that will simply make the apology that much more difficult for them, as it is a fairly well known fact in the industry. Why are short sighted and less forward thinking management types able to convince themselves that lying is a better alternative than admitting the truth, I will never know.

Some of the independent dealers are able to offer commission reduced or free mutual funds, since trailer fees pay them quite well, and make a very decent living, while the major bank owned IDA firms, have a “gag order”, which forbids anyone in the firm from talking publicly about these client friendly forms of competition. Speaking of competition, this seems to fly in the face of the Canadian Competition Act, does it not?

Yes, however, no matter how much the bank owned firms treat advisors as independent agents, they also call them employees when they need to, and the Canadian Competition Act does not apply to employees. So they once again get the best of both worlds. They get to ignore the competition act, while claiming, “trust through integrity in everything we do”.

If you as an investment advisor, make an error, or have a bad client, the firm will make you pay for this error, in violation of employment regulations, as this is in their favor. But if calling you an employee is to their advantage, they will as quickly change gears and state this as the relationship. They call this double dealing, “standard industry practice”, which is another way of saying, “we are large enough to change the rules to suit ourselves, and to hell with you if you do not like it”. Unfortunately this attitude applies to clients as well as employees.

But I digress…………….I was on the topic of how the large firms get away with charging the highest fees or commissions that they have to choose from, while at the same time telling you that they are your agent, advisor, or expert, acting on your behalf to help you meet your financial goals. (see any IDA firm’s advertising for confirmation of this premise)

- Some specific examples of how your advisor places his or her interest ahead of yours:

You decide to buy a mutual fund. Rather than pick one out of a hat, you decide to trust an expert and get some advice. The expert has any one of several ways to buy mutual funds, since the market is now deregulated (remember 1987?). Does the expert advisor advise you to buy the one with the lowest cost to you, and the greatest return potential……….or do they abrogate their professional responsibility and advise you to buy the one that pays them the most?

From industry stats, which state that given identical funds, with identical holdings, and managers, but with different compensation structures to the advisor:
The funds with the higher compensation to the advisor sold at a rate of ***74 times higher*** than the original, lower cost fund choice, in the last ten or so years. Source - Ontario Securities Commission Fair Dealing Model, appendix F, pages 12 and 13 on Compensation Biases. www.osc.gov.on.ca

These two pages that provide an interesting look at what happened when a new style of compensation was introduced to mutual funds back in the '90's. (DSC's) It shows that between otherwise identical funds, the one with more hidden and higher compensation to the advisor sold SEVENTY FOUR TIMES as much in assets over the following ten years than the identical fund with lower and less hidden compensation.

Statistics hold that over 80% of sales of mutual funds in Canada are made with the DSC option, despite the fact that advisors promise to place the interests of the client first and foremost. This promise is evidently not being lived up to.

- Another real life example from www.globeinvestor.com

Trimark's flagship fund began in 1981, had front-end fee option only, MER of 1.62%, total assets of over $3 billion, accomplished in 23 years.

Trimark's Select Growth fund was introduced in 1989, as a clone fund to the above with a DSC sales compensation model as its key-differentiating feature. Its MER is higher at 2.39%, costing the client more, in part to help finance the up front commission that advisors earn. This compensation is more easily hidden, in that the advisor earns his 5% commission without the client seeing it in writing (outside of reading a 334 page legal prospectus). It has total assets of over $6 billion, accomplished in 15 years. (double the size of the original and cheaper run Trimark fund)
Clients pay more in annual fee's to have this fund. Clients are tied to a deferred sales charge that is easily hidden from them. Advisor earns more.

Why is your investment advisor telling you to buy the DSC option?
Is it because it is in your better interest? Or theirs?

I hope this information can be of use to Canadian Investors.

Larry Elford
lelford@shaw.ca

. . .

The following article is reprinted from USA Today, but is not complete. While it speaks of the situation in the United States, small investors are faced with the same problems in Canada. The complete article may be accessed on the Internet at:
http://www.usatoday.com/money/perfi/general/2004-09-14-small-invest-cover_x.htm.

Small investors get no respect on Wall Street

By John Waggoner, USA TODAY

Come to the Vanguard Group with $1 million or more, and you get portfolio advice, low fees and a personal representative to attend to your investment needs.

Come to Vanguard with $10,000, and you get a guy on the other end of the phone.

Come with less than $1,000, you get turned away.

Vanguard is typical. Increasingly, the message from Wall Street is that small investors need not apply. Merrill Lynch, which once bragged about bringing Wall Street to Main Street, requires a $100,000 ante to sit down with a broker. And Charles Schwab, pioneer of discount brokerage, pushed up fees on small accounts in an effort to make them be profitable — or go elsewhere.

Nearly every brokerage, brokerage house and bank has a special team that caters to the wealthy. Small savers, on the other hand, pay more for their investments, get little advice and often get the raw end of investment scams.

All of which could be dismissed as the way the world works, except for one thing: Today's small investors aren't the stock dabblers of a few decades ago, who bought and sold stocks for the thrill of playing the market. They're investors because they have to be. Their retirement depends on it.

Pensions, once a mainstay of retirees, are disappearing. Just 17% of all private employees have traditional defined-benefit pensions, according to the Employee Benefit Research Institute (EBRI), a non-profit research group. That's down from 44% 20 years ago.

If you can't depend on a pension, you have to rely on your savings. But it's expensive to be a small investor. Small accounts cost more to service, and financial-services companies pass on the fees to customers.

The more you pay your fund or your broker, the less you earn, and the less likely you are to have enough to retire.

"Without a doubt, small investors get dramatically inferior treatment," says Douglas Schultz, a Westcliffe, Colo., securities expert.

...

Even at retirement, most people haven't saved enough to be considered large investors by Wall Street standards. The average defined-contribution balance for employees of long tenure and continuous participation is $175,000, EBRI says.

Eating away at earnings

What eats away at small investors' earnings:

•**Account fees.** Charles Schwab & Co., the nation's largest discount brokerage, built its reputation as a champion of the small investor. But Schwab now charges accounts with $10,000 to $50,000 in assets $30 a quarter. That's $120 a year on a $10,000 investment, or 1.2%, and nearly twice what an investor would earn in Schwab's money market mutual funds.

...

•**Commissions.** Buy a mutual fund through a broker, and you'll pay more if you have only a modest sum to invest. Put $5,000 in the American Funds' Investment Company of America, one of the hottest broker-sold stock mutual funds, and you'll pay a 5.75% commission, or load. Invest $100,000, and you pay 3.5%.

Franklin U.S. Government Securities is one of the nation's most popular funds for investors seeking income from their investments. It charges a 4.25% commission if you invest less than $100,000. That's 78% of the income the fund paid out the past 12 months, according to research firm Morningstar. Invest more than $100,000, and the commission falls to 3.5%.

Stock-pickers pay more, too. A regular brokerage account at Fidelity Brokerage (called the bronze level) charges $29.95 to buy stocks. Move to the gold level, and you'll pay $8 a trade. But you'll need to make 120 trades a year and have $30,000 in assets — or have $1 million in assets — to hit gold.

...

Even at the Vanguard Group, noted for its low fees, smaller investors aren't welcome. Minimum investment in a taxable account at the Vanguard 500 Index fund, the nation's largest stock fund, is $3,000. An IRA is $1,000. Investors with less than $10,000 have to pay an additional $10 annual account fee.

"My favorite fund company isn't that small-investor friendly," Barbara Roper, director of investor protection at the Consumer Federation of America, says of Vanguard.

The Valley Forge, Pa.-based company says it averages just $7.50 on a $3,000 account. "It doesn't begin to cover costs," says company spokesman Brian Mattes.

Small investors get less

Not only do small investors pay more, but they get less — particularly when it comes to advice.

...

At Merrill Lynch, investors with less than $100,000 are directed to a call center, where they can speak to a Merrill representative on the telephone.

If you've got the money, however, you can get advice, lower fees, or both:

...

Only the wealthy need apply

Mutual funds have held themselves out as trustworthy but have treated small investors worse than gamblers at a casino, says William Galvin, Massachusetts secretary of state. "At least at a casino, you get free drinks."

"Everyone wants the wealthy investors. The small investor doesn't have a lot of advisory resources or friends in the mutual fund industry," says Roy Weitz, publisher of FundAlarm.

...

Reprinted from USA Today

. . .

"He who understands interest -- earns it. He who doesn't understand interest -- pays it."
- Richard Russell