SIPA Sentinel

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Small Investor Protection Association - A voice for small investors

"Pig in a Poke" P.O.S. Disclosure

After a much ballyhooed Point of Sale disclosure, the fund industry has introduced Fund Facts. While the initiative to provide better disclosure for investors at the point of sale, this substitution of fund facts is ridiculous in the extreme. It is not only defective in its failure to adequately define the risk, but the fact that the regulators allow it to be provided after the sale defeats the purpose of point of sale disclosure. The net result is fund investors end up still buying a pig in a poke.

Mutual Fund Risk Reports Confusing

So says Ellen Roseman in a recent Toronto Star article. Most Canadian investors do not realize the risks associated with mutual funds. There has been much discussion about Point of Sale disclosure over many years. Finally the regulators are requiring firms to provide disclosure of details and risks associated with mutual funds.

Ellen writes *"Starting this month, all mutual funds sold in Canada have to provide a standard plain-language document called Fund Facts, which describes the risk in a word or two. You can find the information online at mutual fund companies' websites and at www.sedar.com, a free public database of disclosure documents."*

Investor advocates acknowledge that the provision of Fund Facts is a giant step forward but are critical that the fund facts do not disclose essential information to enable investors to properly evaluate funds. The problem is that the degree of risk is not adequately defined and may vary from manager to manager thus leaving investors in the dark. Ellen writes "*But when it comes to disclosing risk, Fund Facts gets a failing grade. Managers can rate the risk of their own funds, using five descriptions: Low, Low to Medium, Medium, Medium to High, and High. Here's the problem: managers think their funds are less risky than investors think they are."*

During the market meltdown in 2008, some funds described as medium risk fell by more than 50% while the general market represented by the S&P/TSX index fell 35%.

One of the greatest deficiencies of the new Fund Facts is the failure to require an appropriate benchmark for comparison. It is most important for investors to compare performance of investment products to appropriate benchmarks. This also applies to your investment account. An article in the February 2011 issue of the Sentinel indicates how you can determine your rate of return, and how you can determine an appropriate benchmark for comparison.

Ellen writes "*But securities regulators have different needs. To keep Fund Facts short, they don't require including a benchmark. I hope they rethink this decision. Unless managers show their own returns and the appropriate benchmark's returns, investors can't judge results in a meaningful way."*

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So there you have it. A government-run effort to protect mutual fund buyers falls down when it comes to measuring risk. Instead of helping people understand risk, Fund Facts can mislead them. Regulators, please fix the problem. Don't let your desire for being concise overwhelm the demand for being clear and avoiding confusion."

Ellen Roseman writes about personal finance and consumer issues. You can reach her at eroseman@thestar.ca

Client Statements Can Be Misleading

Recently I was contacted by April, a member for some years, asking if I would look at her statement. She said it showed a 24% return for the last year and she was invested in mutual funds. As this seemed highly improbable I agreed to review her statement with her. From previous conversations I believed she had adequate knowledge but during our discussion I realized that many investors do not understand the significance of annualized rates of return. This means simply the annual rate of return.

It is important to know the annual rate of return so it can be compared to a benchmark, or in other words, an annual rate of return of something like Canada bonds, or the return on the stock market. If you own mutual funds that contain equities (or shares) the S&P/TSX index is a good benchmark.

I was not surprised to see that indeed April's statement from Primerica indicated a return of 24%. She had invested in five different funds and some of these had been turned over a year or so ago. The return was for her account but it was not an annualized rate of return it was the return from inception. As she had opened her account in 1999, her investments were for a period of 12 years. The annualized rate of return was close to 2% per year.

April's situation is not unusual. Many investors fail to understand the importance of knowing the annual rate of return. The rate of return must be related to time if it is to be compared. That is why your statement should indicate the annualized rate of return so it can be compared to a benchmark to determine whether your "advisor" is looking after your interests or not. The so-called "Advisor" may not fully understand the concept of annualized rates of return, but it seems common practice for firms to avoid providing rates of return compared to benchmarks. The fact is most accounts would not compare well to benchmarks.

Be Cautious About Investing in ETFs

For some time we have been cautioning investors about investing in products labeled as ETFs. When ETFs were first introduced they were a bit similar to mutual funds in that they provide diversification but they were structured to closely follow the stock market and had minimal fees. Do It Yourself investors recognized the advantages of these products over mutual funds and began to migrate to them.

The investment industry noticed this migration and in response started developing products similar to ETFs but based on particular market sectors and products other than stocks or shares. These innovative products soon flooded the market and the fees were higher than for the regular ETFs but generally less than for mutual funds to attract investors. However many of these ETF products proved to be unsuitable for investors wanting to provide security for their savings. A recent article by James Langton in Investment Executive highlights the issues related to these innovative ETF products.

> ***U.S. regulators seek penalties against RBC Capital Markets***
> ***Former rep improperly sold leveraged and inverse ETFs, regulators allege***
> *By James Langton, IE*
>
> *Securities regulators in Massachusetts allege that a former rep with RBC Capital Markets improperly sold leveraged and inverse exchange-traded funds.*
> *On Wednesday, state regulators charged the firm and a former rep with selling these complex, exotic ETFs to investors who didn't understand them, and says that clients lost almost $800,000 in total as a result. They also claim that the firm didn't provide proper training about the products, and that inadequate supervision allowed the rep make numerous unsuitable recommendations.*
> *Regulators are seeking a cease and desist order, disgorgement to investors, and administrative penalties, against both the firm and the former rep in the case. The allegations have not been proven.*

Investor advocates such as FAIR Canada have warned that these sorts of products are generally not suitable for long-term investors, and regulators have issued their own warnings about them too. According to the complaint, the firm stopped solicited sales of these products to clients in December 2009, and also began providing additional disclosure on unsolicited sales.

This article illustrates several issues:

- Complex exotic ETF products are sold to investors who do not understand them
- The products were not suitable with the result investors experienced loss
- Representatives may not understand the innovative products they sell
- Supervision of representatives and client accounts is often lacking
- U.S. Regulators often act more quickly than Canadian Regulators

The Autorité des marchés financiers (AMF) takes action in Québec

Although regulators in the rest of Canada seem unwilling or unable to take action to ensure that victims of investment fraud and wrongdoing are compensated, the AMF in Québec is leading the way in establishing a regulator that encompasses the banks, insurance companies and fund companies as well as the securities dealers. It is unfortunate that the Government has restricted its vision of a national regulator to that of securities only. For that reason it is improbable that Québec would join this initiative. SIPA had recommended that Government develop a national financial services regulator based upon the Québec model.

Regularly there are reports from Québec on action taken by the AMF.
The following report was published in the Investment Executive.

AMF seeks $710,000 in fines related to illegal securities distribution
Investigation shows investors lost approximately $287,600
By Megan Harman, Monday, July 18, 2011

The Autorité des marchés financiers is seeking fines totaling $710,000 and a prison term against an individual and four companies involved in the illegal distribution of securities.
The AMF said on Monday that it has launched penal proceedings in Laval against Manuel Da Silva, Aquagold International Inc., Sources d'eau bleue du Québec, Aquablue International inc. and Aquablue Spring Water International Inc.
In March 2010, the Bureau de décision et de revision found that Da Silva, chief executive and chairman of bottled water company Aquablue, had made representations to potential investors about projects to sell bottled water in China, the acquisition of a bottling plant in Smith Falls, Ontario, and an exchange listing of the shares sold to investors.
An investigation by the AMF showed that 16 investors lost approximately $287,600 in connection with this matter.
On March 5, 2010, at the request of the AMF, the Bureau de décision et de révision issued freeze and cease trade orders against Da Silva, as well as an order to cease any activity as a securities advisor. A cease trade order was also issued against Aquablue International and Aquablue Spring Water International.
The AMF has now filed 32 charges against Da Silva: 14 for illegally pursuing activities as a securities dealer or advisor, 12 for aiding with an illegal distribution, three for declaring that shares would be listed, and three for making misrepresentations.
The securities commission is seeking fines from Da Silva totaling $485,000, as well as a prison term.

The AMF has also filed seven charges for illegal distribution against Aquagold International, Sources d'eau bleue du Québec, Aquablue International and Aquablue Spring Water International. It is seeking fines totaling $225,000 from the four companies.

Fraud is widespread across Canada

Fraud is widespread across Canada. Canada needs to take a firm stand against financial crimes. The future security of Canadians is at stake. Losses due to investment fraud and wrongdoing are estimated to be greater than $25 billion per year. While this may be only a small percentage of total investments, for the victims it is a life altering experience. Most Canadians do not have a workplace pension and must depend upon their savings and investments to supplement Government security plans. As the move to defined contribution pension plans accelerates it becomes ever more important to stem the growth of fraud. A recent report from the Calgary Herald outlines one of the many frauds occurring in Canada.

Alleged fraud cost millions: ASC

Kim Guttormson - Calgary Herald - Tue Jul 19 2011

A Calgary company raised millions from investors for real estate deals with companies which didn't actually own the properties, and funnelled $7 million from one specified project to others, an Alberta Securities Commission hearing heard Monday. "This is a case about deceit," ASC lawyer Tom McCartney told the panel. Shire International Real Estate Investments Ltd. and its president and sole director Jeanette Cleone Couch, as well as related entities, made false and misleading statements in an offering memorandum related to property in Hawaii and "perpetrated a fraud" on investors relating to a Calgary site, the ASC alleges.

Couch, who is representing herself and the companies at the hearing, said she will make an opening statement after the ASC finishes with its evidence and will call one witness. The charges against Shire and Couch relate to two offering memorandums. One was called the Hawaii Fund, which the ASC alleges raised about $1.3 million from 107 investors between January and June 2009, and the other was Bearspaw at 144th Avenue Ltd., which the ASC believes raised between $16 million and $20 million from 844 investors between August 2007 and June 2008.

"All these projects failed and it appears most investor money has been lost," McCartney told the hearing. In the case of the Bearspaw development, the ASC alleges that while more than enough money had been raised for the $13.8 million purchase price, two mortgages were taken out on the property. As well, the ASC says more than $15 million was transferred from the Bearspaw account to Shire and of that, according to investigators, at least $7 million was used for transactions not related to Bearspaw, including other real estate deals connected to Couch and her daughter.

The ASC also says there was a $100,000 payment to Couch. The Bearspaw property is in foreclosure, the ASC said. The Hawaii Fund involved two properties on Maui which the offering memorandum stated were to be purchased from companies which in fact didn't own them, the ASC alleges. Investigator Viola Pickering, who testified Monday, said Shire first came to the ASC's attention when the owner of one of the Hawaii properties contacted them, because the two luxury homes had not been purchased as stated. As well, the numbered company Shire said it had a deal with for the other purchase (although that company didn't actually own the property, which contained 32 condo units) had as its sole director Shire's vice-president of special projects, a fact that wasn't disclosed, the ASC said.

Couch's husband had previously been listed as a director of that company. Pickering told the panel that when they launched the investigation, they were "primarily concerned with misrepresentation and fraud." She also said Shire's promotional material stated they were expecting returns of 43.6 per cent over two years on the two Hawaii deals.

Do Canadian Regulators Protect Investors?

Many believe that Canadian regulators are slow to act and do not protect investors. U.S. regulators are investigating wrongdoing and in some cases are sending Canadians to prison when they take advantage of U.S. investors. The January 2010 Sentinel contained the following warning *"The term Exchange-Traded Funds is used to describe a category of products, some very risky, some not so risky. Before making a decision to invest in an ETF, you need to find out what kind of ETF is being proposed.*
If you are considering a "leveraged" or "inverse" ETF, make sure you understand just how risky that might be. There are 15 leveraged ETFs and 19 inverse-ETFs trading in Canada today. Leveraged and inverse ETF products are better suited to professional investors than they are to retail investors. Professional traders use these short-term trading vehicles to speculate, or to hedge other positions they hold."
Recently U.S. regulators took action and charged Canadians with selling "complex, exotic ETFs" to unsuspecting investors. Investment Executive published the following article.

U.S. regulators seek penalties against RBC Capital Markets
Former rep improperly sold leveraged and inverse ETFs, regulators allege
Wednesday, July 20, 2011 - By James Langton

Securities regulators in Massachusetts allege that a former rep with RBC Capital Markets improperly sold leveraged and inverse exchange-traded funds.
On Wednesday, state regulators charged the firm and a former rep with selling these complex, exotic ETFs to investors who didn't understand them, and says that clients lost almost $800,000 in total as a result. They also claim that the firm didn't provide proper training about the products, and that inadequate supervision allowed the rep make numerous unsuitable recommendations.
Regulators are seeking a cease and desist order, disgorgement to investors, and administrative penalties, against both the firm and the former rep in the case. The allegations have not been proven.
Investor advocates such as FAIR Canada have warned that these sorts of products are generally not suitable for long-term investors, and regulators have issued their own warnings about them too.
According to the complaint, the firm stopped solicited sales of these products to clients in December 2009, and also began providing additional disclosure on unsolicited sales.

Why You Need To Know Your Annualized Rate Of Return

What is an Annualized Rate Of Return? It is simply the percentage earned by your investment over one year. Most interest rates are expressed as annual rates. For example a savings account may pay 1/2 per cent (0.5 per cent) per year on your savings and your mortgage may charge 4% per year on the outstanding amount of your loan.

However many small investors receive reports investment reports indicating a rate of return higher than 20%, but this is not an annualized rate of return; it is the total return over an extended period.

It is essential that you understand the actual rate of return for each year. That is why we recommend asking your representative to provide you with an annualized rate of return so you can compare it to other possible investments.

For example Canada Bonds are paying approximately 3%, Corporate Bonds (with slightly more risk) are paying approximately 5%, and the major banks preferred shares are paying about 5.5 %. Investing in common shares will provide dividends from the major banks of 3.5% to 4.5% or if you simply but the ETF index XIU tracking the Toronto stock market the dividend rate is about 3%. The value of common shares may vary up or down but long term investment grade dividend paying shares will generally provide the best return so it may be appropriate for most investors to have at least a portion of their investments in dividend paying shares.

In early July one of our members asked me to look at her statement. April said she was investing with Primerica and has a return of 24%. When I questioned whether it was an annualized rate of return she seemed not sure so I offered to review her statement with her as many of the client statements provided by the investment industry can be misleading, and few actually provide the annualized rate of return. So this is what was found.

In 1999 April inherited a low six figure amount but had no experience with investing so on the advice of a colleague she invested her money with Primerica. Her account was placed in several different mutual funds mostly based on equities. The first year results were quite good and April was assured she could withdraw some of the funds to purchase a vehicle and make some renovations without drawing down her initial investment. However subsequent performance was not good, and today her total investment are much less. Sure enough the rate of return for her account was shown as 24%, but it was from inception (1999) which made it a 12 year period (This is approximately an annualized rate of 2% per year.)

We recommend small investors use the ETF of the Toronto Stock Market (XIU-T) as a benchmark to compare their account performance if they are invested in mutual or segregated funds. While this may not be exact it will certainly be an eye opener for most fund investors.

In Aprils case, if she had invested in the ETF of the Toronto Stock Market (XIU-T) she would have realized a total return over 12 years of approximately 70% or over 5% per year. The current dividend rate for XIU is 2.3%.

Bank shares of the major banks over the last ten years increased by a total of 40% to 150% depending on the bank. Current dividend rates for the banks vary from 3.4% to 4.6% per year.

It is my opinion that there are few funds that will outperform the ETF of the Toronto Stock Market (XIU-T) over the long term. Some funds may have a very good year but few funds will outperform over the longer term.

IT IS FUNDAMENTALLY IMPORTANT THAT YOU KNOW THE ANNUALIZED RATE OF RETURN ON YOUR INVESTMENTS. . ASK YOUR REPRESENTATIVE TO PROVIDE THIS TO YOU.

The February 2011 Sentinel provides details of tools to enable you to check the annual rate of return on your investments and how to determine an appropriate benchmark.

How Do Your Investments Stack Up?

Many investors are confused by rate of return. Normally the rate of return refers to the annual percentage gain in your investment. When the investment term is longer than one year the annualized rate of return (the average annual rate of return) is used for comparison. It is not uncommon for the investment industry to report your return from inception. This may be misleading. A 25% return over ten years may indicate problems. Use this simplified chart to compare your rate of return:

	Account	XIU	BNS	BCE	AGF
Market Value Dec 31, 2009 [A]	A	17.37	49.22	29.00	17.00
Cash In [B]	B				
Cash Out [C]	C				
Net Cash Invested [A+B-C] = [D]	A+B-C	17.37	49.22	29.00	17.00
Market Value Dec 31, 2010 [E]	E	19.29	57.10	35.34	19.49
Gain/Loss [E-D] = [F]	E-D	1.92	7.88	6.34	2.49
Rate of Return 2010 [F/D]	(E-D)/F	11.05%	16.01%	21.86%	14.65%
Dividends are paid in addition.		2.30%	3.60%	5.50%	5.80%

If you invested in equity based funds and your return is less than that for XIU, you should get a second opinion on your investments.

Whistle-Blowers Expose Wrongdoing

Whistle-Blowers or Truth Tellers have become an essential part of our society. The exposure of major wrongdoing often depends on some brave person coming forward to tell the truth. Unfortunately most of these individuals have been persecuted losing their jobs and often their careers. Joanna Gualtieri is one of Canada's best know Truth Tellers and she came forward to expose Government wrongdoing. While there is a legislative imitative to provide protection for Federal Government employees it needs to be extended to protect all Canadians in every industry. In 1998 Joann Gualtieri founded the Federal Accountability Initiative for Reform. The following is from their website.

FAIR (Federal Accountability Initiative for Reform) *promotes integrity and accountability within government by empowering employees to speak out without fear of reprisal when they encounter wrongdoing. Our aim is to support legislation and management practices that will provide effective protection for whistleblowers and hence occupational free speech in the workplace.*

Founded in 1998 by Joanna Gualtieri FAIR is a registered Canadian charity, run by volunteers. The Executive Director David Hutton is supported by an eminent Advisory Board which includes David Kilgour, David Swann, Gerard Seijts, Robert Stenhouse and Bob Gale.

Recently the U.S. Securities and Exchange Commission announced new rules to encourage whistle-blowing. The following was published in the Economist.

The SEC's new rules on whistle-blowing
The SEC offers a huge carrot to encourage whistle-blowers
"TOO many people remain silent in the face of fraud," says Mary Schapiro, the chairman of America's Securities & Exchange Commission (SEC). On May 25th she announced new rules to encourage corporate whistle-blowing. Inducements will include cash: 10-30% of fines of over $1m that result from tip-offs. The US Chamber of Commerce, a business lobby, calls it a "bounty programme" that will reward "amateur sleuths in search of a big payday". It is threatening legal action to block it.
The new rules were required by the Dodd-Frank act, Congress's response to the financial crisis, which was passed last year. They follow an earlier effort to encourage employees to speak up. After Enron, an energy firm, collapsed in a flurry of fraud, Congress passed the Sarbanes-Oxley act in 2002 which, among other things, protected whistle-blowers from retaliation.
Employees have never found it easy to squeal on employers. Perhaps the most celebrated of corporate whistle-blowers, Sherron Watkins, a former executive at Enron, never went public with her prediction that the company might be brought down by fraud. She reported her concerns internally, and was ignored.
When the SEC released draft rules in November, businesses fretted that the financial rewards would prompt insiders to go straight to the commission, bypassing their firms' internal procedures—especially since that would reduce the risk of being victimized by the boss or branded a "disgruntled employee". The new rules try to correct this, for example by allowing a reward to be paid in some circumstances to whistle-blowers who only grumble internally.
The chance of making a fortune may encourage speculative whistle-blowing in the hope of winning the lottery. Ms Schapiro's new Office of the Whistleblower may be deluged with useless tips. But even that might be better than the status quo.

The OSC is now considering how whistle-blowing protection could be implemented in Ontario. It is hopeful that legislation for a national securities regulator will also address this important issue.

VOICES for Investors

There are many voices for investors. Canadians are speaking out and contacting Government and regulators. These many voices will help to influence action by Government and regulators.
For many years SIPA has used the slogan *"A voice for small investors".*
Kenmar Associates uses the slogan *"The Voice of the retail investor".*
FAIR Canada uses the slogan *"The Voice for Investors".*
The OSC Investor Advisory Panel has been called *"A voice for investors".*
An investor advocate website is *"investorvoice.ca"*
There appears to be a new awareness that investors are one of the stakeholders in the investment industry and should be listened to. However, change occurs slowly and there is resistance to change. Canadians need to become aware of the risks associated with various types of products and be aware that they need meaningful reports they can understand, and the need to monitor these reports.