CARP

GIVING SMALL INVESTORS A FAIR CHANCE:

Reforming the Mutual Fund Industry

Carp's Report and Recomendations

In partnership with Small Investor Protection Association (SIPA)

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Introduction

Canadians who are retired or approaching retirement cannot afford to lose their life savings. Most Canadians do not have good investment knowledge and tend to rely on a salesperson or broker for investment advice. The advice inevitably includes an investment in mutual funds.

Approximately ten million Canadians hold mutual funds in their Registered Retirement Savings Plans (RRSPs) or in regular investment accounts. Some are even being advised to borrow money to invest. They are convinced that by using leverage they can improve the return on their invested assets, but they are not always advised how leverage increases their risk.

CARP in partnership with the Small Investor Protection Association (SIPA) has reviewed the mutual fund industry and how Canadians over fifty can be adversely affected by investing in mutual funds – especially when given inappropriate advice.

Mutual funds are in principle a sound investment vehicle and an important factor in an estimated 50% of Canadian households.[i]

However, over the past decade many studies have identified the need for enhanced mutual fund investor protection. In 1998, former Ontario Securities Commission Commissioner, Glorianne Stromberg prepared a comprehensive Report entitled “Investment Funds in Canada and Consumer Protection: Strategies for the Millennium”. This Report examined requirements for the reasonable protection of investors and made recommendations to enhance investor protection. Very little has been done since its release. In December 2003 a Regulatory Burden Task Force[ii] assigned by the Ontario Securities Commission (OSC) made 108 recommendations, some of which are echoed in this Report. A June 2004 Globe and Mail six-part series about the industry found examples of trading abuses, loosely enforced regulations, proposed new rules that would impair investor protection and excessive fees.

The consensus is that Canadian mutual fund investors are losing money due to:

- Deficient regulations
- Abusive industry sales practices
- Excessive fees
- Inadequate governance
- Lax regulatory enforcement

These factors can negatively affected the standard of living and future retirement expectations of investors. This, in turn, impacts on their physical and emotional well being. Mutual fund investors, particularly seniors, have, with reason, become increasingly concerned about the security of their investments.

In the U.S., investigations by the Securities and Exchange Commission, the House of Representatives and Eliot Spitzer, the New York State Attorney General, have discovered a rash of shortcomings and wrongdoings in the mutual fund industry. Canadian investors are therefore aware that the Canadian mutual fund industry could also be susceptible to fallout from:

- Poor fund governance
- A collapse of fiduciary responsibility
- An abundance of conflicts of interest

Fundamental change is essential.

A snapshot of the Canadian mutual fund landscape:

- $451.6 billion of investors' money has been entrusted to the mutual fund industry[iii]
- Investors were charged over $10.1 billion in fees in 2002[iv]
- A recent Ipsos/Reid poll[v] found that:
  - 41% of investors in mutual funds do not know what types of mutual funds they own
  - 51% of mutual fund investments are in RRSPs
  - 36% of RRSPs are heavily weighted in mutual funds
- Mutual funds are used extensively for children's education or other major life events
- Industry trade associations such as the Investment Funds Institute of Canada (IFIC) and the Investment Dealers Association of Canada (IDA) have influence on statutory regulators, unlike investors who are marginalized
- The Mutual Fund Dealers Association (MFDA) is responsible for regulating the distribution of mutual funds
- The provincial securities commissions and administrators are responsible for regulating the mutual fund companies and overseeing the activities of both the IDA and MFDA
- Mutual funds are viewed by regulators and industry participants as consumer products, not investment management services
- Recommended regulatory reforms, which would protect investors, are very slow to be instituted
- Investor protection appears not to be high on the Canadian political agenda - unlike in the U.S.A
- An investor's ability to obtain financial redress is limited, complex, time-consuming and expensive.
- According to a MFDA bulletin[vi] released in February 2004, following an onsite compliance review of its members, there were 44 breaches of MFDA rules or other applicable statutory requirements discovered. For example:

Common deficiencies

- Content of client account statements not conforming to MFDA rules
- New Account Application Forms (NAAF) incomplete and excluding certain pieces of Know Your Client (KYC) information required to ascertain suitability of trades
- NAAFs not signed and/or dated by clients
- Leverage disclosure documentation not provided to clients at time of account opening
- Unsuitable trades compared to the client's KYC information
- Lack of evidence of client authorization for trades
- Trades not processed in a timely manner
- No evidence of trades reviewed for suitability by client
- No evidence of client instructions for trades pursuant to limited trading authorization
- No log of client complaints
- No response in writing to client complaints, either to acknowledge receipt or to convey the results of investigation
- Commingling of client's cash with agent's own property
- No distribution of interest earned in mutual fund trust account
- Policies and Procedures Manual (PPM) not complying with all of MFDA requirements
- Misleading advertisements

Uncommon deficiencies

- Advisor engaging in discretionary trading in client's accounts
- Excessive trading in client's account to generate commissions
- Misappropriation of client's funds or securities.

A USA magazine, Registered Rep, published the following in an article entitled "OSC Slams Fund Dealers" dated December 1, 1997[vii]:

"The Ontario Securities Commission, Canada's largest provincial regulator, has uncovered numerous regulatory abuses by mutual fund dealers, including poor supervision of salespeople and improper commingling of client funds.

'I don't think it would be an exaggeration to say we were shocked at what we found,' says Toni Ferrari, manager of compliance in the OSC's division of market operations.

'When you see any widespread disregard of accepted operating procedures, it makes you wonder about what else may be going on,' says Ferrari.

What else is going on, according to the findings, is that many of these firms have not been properly supervising their salespeople. Sixty percent of the firms, the audit showed, were flagged for numerous sales violations, including a disregard of standard Know Your Client rules, according to Ferrari.

Further, there were numerous instances in which clients were encouraged to leverage fund holdings.

'Leveraging is not appropriate for most investors. At the very least, clear written internal guidelines are supposed to be in place advising who should and should not be borrowing money,' Ferrari says.

The findings are the result of a two-year investigation that audited the sales practices of 23 mutual fund distributors. The audit showed that 80% of the companies had not followed regulatory guidelines."

More recently, the 2004 OSC Capital Markets Compliance Report, published in July, observed the following:

- Internal marketing requirements were not being adhered to
- Marketing materials contained information that was incorrect
- Marketing materials were outdated or had inadequate disclosure
- Web-site information was incorrect, outdated or contained inadequate disclosure
- Performance data included accounts not managed by the Investment Counsel and Portfolio Managers (ICPM)
- Performance data incorrectly used return data from a different fund or period
- Composites used in marketing materials did not include all the fee-paying accounts or were not grouped according to similar investment mandates
- References to the Association for Investment Management and Research (AIMR) were used when the firm was not AIMR compliant
- Claims of "superior performance" were made that could not be substantiated
- Claims regarding the future value of investments were exaggerated
- The disclosure and warning language required by 15.2(2) of NI 81-102 was not always present
- Performance data of mutual funds was not disclosed for the required time periods
- No evidence was maintained of any review of marketing material

All of these items had been reported a year earlier including suggestions for improvement. It appears that the industry either ignored the OSC and/or has no quality control system.

Giving Investors a Fair Chance:

RECOMMENDATIONS TO REFORM THE MUTUAL FUND INDUSTRY

1 In order to ensure investor protection, a federal Investor Protection Act should be passed which includes the establishment of a single, national independent Investor Protection Agency (IPA) accountable to Industry Canada or the Attorney General of Canada.

The IPA, in collaboration with provincial regulators, should be empowered to:

- oversee the regulatory bodies
- establish a central registry of industry participants
- create a central database of complaints
- monitor dispute resolutions
- order independent investigations or inquiries
- order restitution in cases of industry wrongdoing.

2 An Investor Advisory Council, consisting of organizations such as SIPA and CARP, should be set up and funded by securities regulators. The mandate of this Council should be to:

- review existing legislation and recommend reforms
- recommend regulation or policy reforms
- engage in public consultation and surveys.

The Council should publish an Annual Report on its activities.

3 Federal legislation should create a fund – like the Canada Deposit and Insurance Corporation – to protect investors from the insolvency of mutual fund dealers. Fund companies should also be required to carry an appropriate level of Errors and Omission Insurance.

4 Federal legislation should guarantee prompt and fair handling of investor complaints. Mutual fund companies must make public their complaint processes and procedures.

Regulations should require firms to:

- maintain and retain records of all complaints received
- report how and when they were resolved
- submit this information to regulatory authorities on a monthly basis.

An awareness campaign on how the complaint system works should be included in the legislation.

The Investment Dealers Association of Canada (IDA) should increase the arbitration limit from $100,000 to $350,000.

Development of new policies and procedures should be based on analysis of the complaint database.

5 Public announcements should be made when a seller of financial products is under investigation, citing the reasons for that investigation. This would permit investors to make a more informed decision when considering whether to maintain or open an account with a prospective dealer. Any reprimands or warnings issued by Self Regulatory Organizations (SRO) should also be made public.

6 Truth-teller (whistleblower) legislation, including employment protection, is required to protect informants.

7 Investors must be given a standard prospectus in simple language prior to investing. The document should include all risks associated with the specific fund, the measures taken to mitigate them, and their potential impact.

8 Advisors must keep and annually update a Know Your Client (KYC) form for every client – sometimes referred to as a New Account Application Form (NAAF) – for three purposes: to profile a client in order to provide appropriate advice; to bind the advisor to the needs of the client; and to make actionable advisor's recommendations that are clearly contrary to the interests of the profiled client.

A standardized purchase/switch fund checklist form that highlights key mutual fund characteristics such as fees, risks and advisor compensation should be made available and at the investor's option jointly signed by the client and salesperson. Both parties should retain a copy, as a reference point in case of disputes.

Undisclosed marketing arrangements that could encourage financial advisors to recommend one fund over another for personal/corporate gain should either be disclosed or prohibited.

Promotion of corporate sales and/or profits rather than serving the needs of the client should be subject to penalty.

9 Investors should receive a description, accompanied by a graphic representation, of a breakdown of Management Expense Ratio(MER) charges over for 1, 3, 5 and 10 year periods based on varying investment amounts. It should be specified that only the MER is reflected in the description, not RRSP fees, switch fees, transfer fees, brokerage expenses etc.

Some MER cost elements should be itemized for greater investor transparency, such as

• marketing and distribution fees (as is required by the U.S. Securities & Exchange Commission)

• disclosure of actual sales commissions and trailer commissions (continuing payments to salespersons as long as an investor stays invested in the fund) to identify potential conflicts of interest of advisors' recommendations.

10 Federal legislation should mandate that a Governance Board of Directors must contain a majority of independent directors, including an independent chairman and investor. This Board should at least deal with:

- real or perceived conflicts of interest
- internal controls
- business practices
- expenditures
- financial statements approval
- asset valuation methodology
- evaluation of management performance

Board member compensation and the level of personal ownership within the funds should be disclosed. In addition, a fund company compliance officer should be required to report to the Board of Directors.

11 Federal legislation should mandate that mutual fund Annual Reports be issued to investors unless specifically declined by them.

12 Annual Reports should include disclosure of all costs of a fund including marketing and distribution fees. They should provide a plain language summary of statistics describing the fund's volatility and sensitivity to market conditions as well as the impact of income taxes on fund returns. The current reporting of fund portfolio turnover percentage should be replaced by clearer measures such as the average time a stock is held within a mutual fund.

The Reports should also include the equivalent of a Management Discussion & Analysis to enable investors to better understand what actually happened to their money.

Financial reporting should be on a quarterly basis.

13 There should be federal regulations to provide increased visibility of annual and cumulative returns on investments, costs (including cumulative fees paid to the mutual fund management company), risk and tax related issues. All investors should receive statements, clearly and simply indicating:

• portfolio holdings with complete nomenclature/fund code

• personalized rate of return per fund and entire portfolio

• total cash invested compared to current market value

• appropriate measure of portfolio risk

• performance vs. funds' designated performance benchmark indices

• personalized pre- and post –tax information

This will help investors determine how their mutual fund portfolio is performing and thus better plan for their retirement.

14 Federal regulations should force fund promoters to clearly display benchmark comparisons and fees. In addition, there should be a requirement to disclose the fund's worst 12-month performance in order for investors to appreciate volatility. This statistic should also be included in both the prospectus and Annual Reports.

15 Fund companies should be required to disclose:

• the level of ownership in fund units by the fund executives (insiders)

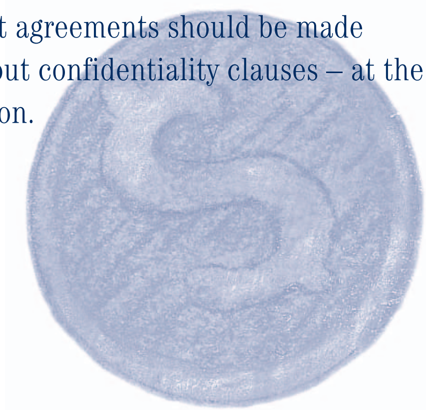
• the method and amount of compensation paid to the portfolio manager and key executives

• the proxy share voting policies of the fund and the actual voting results with accompanying rationale for the positions taken

As part of its fiduciary responsibilities, mutual fund managers should adopt progressive proxy voting policies to build better-managed companies, reduce firm-specific risk, and yield stronger financial performance.

16 Federal regulations should establish guidelines, restrictions and disclosure requirements for educational financial/investment seminars. In addition, investors must be given, and informed of, a "cooling-off" period of, for example, 15 days from receipt of the advisory in order to cancel the transaction without penalty.

17 Settlement agreements should be made public - and without confidentiality clauses – at the investor's discretion.



Problems & Solutions

1. Lack of National Investor Protection

Although Canadians make investments in various provincial financial markets across the country, the current regulation system does not provide uniform securities laws, enforcement or protection.

> *"We will strive for the appropriate balance between investor protection and the business realities of the distribution business."* -MFDA web site[viii]

The reality is that non-statutory SROs, such as the IDA and MFDA, have not provided a fair balance between the interests of investors and those of their member firms. In fact, inherent conflicts of interest exist within the regulatory system.

Arthur Levitt, Chairman of the U.S. Securities Exchange Commission during the Clinton Administration, made the following assessment:

> *"All self-regulatory organizations claim to place the public interest above all else… but all SROs, when push comes to shove, favour their listed companies or the brokers that bring them the business. That may be all right in a marketing sense. But the conflict is too great to be allowed to stand."*[ix]

Recommendations

In order to ensure investor protection, a federal Investor Protection Act should be passed which includes a single, national independent Investor Protection Agency (IPA) accountable to Industry Canada or the Attorney General of Canada.

The IPA, in collaboration with provincial regulators, should be empowered to:

- Oversee the regulatory bodies
- Establish a central registry of industry participants
- Create a central database of complaints
- Monitor dispute resolutions
- Order independent investigations or inquiries
- Order restitution in cases of industry wrongdoing.

2. Muted Investor Voice in Regulatory Process

The investor is ignored when setting new regulations or amending existing ones as opposed to industry participants like the IDA and the IFIC.

Recommendations

Securities regulators should be required to actively seek – on a regular and established basis - input from investors.

An Investor Advisory Council consisting of organizations such as SIPA and CARP should be set up and funded by securities regulators. The mandate of this Council should be to:

- Review existing legislation and recommend reforms
- Recommend regulation or policy reforms
- Engage in public consultation and surveys.

The Council should publish an Annual Report on its activities.

3. No Investor Protection Fund

The Canadian IDA Member Protection Fund provides some protection for investors when an IDA company goes bankrupt. It does not provide protection if fund units are held with non-IDA members.

Recent ads by the Canada Deposit and Insurance Corporation (CDIC) made the point that mutual funds are not covered by the CDIC even though many investors incorrectly assume they are protected.

Recommendations

Federal legislation should create a fund like the Canada Deposit and Insurance Corporation to protect investors from the insolvency of mutual fund dealers. Fund companies should also be required to carry an appropriate level of Errors and Omission Insurance.

It should be noted that mutual funds themselves are not protected and should be considered as part of a broader investor protection initiative. Industry participants argue that all securities are held with a third party custodian and thus there is no risk to investors. This point should be more closely examined to determine any risk and to provide protection and improved disclosure to the investor, if there is a risk.

4. Complaint Systems are Foggy and Ineffective

Mutual fund complaint mechanisms are not accessible or even understood by investors. Attempts for restitution from improper advice have generally led to more stress, legal expenses and aggravation.

Some fund companies tend to prolong the process, eating up valuable time and money.

Both the IDA Alternative Dispute Resolution (ADR) Program and Ombudsman services are sponsored by the industry players themselves. The investor's only other alternative is civil court - a costly and time-consuming exercise.

Recommendations

Federal legislation should guarantee prompt and fair handling of investor complaints. Mutual fund companies must make public their complaint processes and procedures.

Regulations should require firms to:

- Maintain and retain records of all complaints received
- Report how and when they were resolved
- Submit this information to regulatory authorities on a monthly basis

An awareness campaign on how the complaint system works should be included in the legislation.

The IDA should increase the arbitration limit from $100,000 to $350,000.

Development of new policies and procedures should be based on analysis of the complaint database.

5. Ineffective Regulation

The regulation of the securities market in Canada has not evolved at the same speed, breadth and sophistication as the marketplace. David Brown, Chair of the Ontario Securities Commission, stated on September 20, 2002:

> *"Somebody said to me – 'Boy, if we have a scandal in Canada, we are going to have to be as transparent as the United States.' And I said, 'Well, if we are, we could just destroy our markets.' "*[x]

There are too many instances where brokers and salespersons have breached the rules and have only received reprimands while having caused investors to lose their savings. Since these reprimands do not go on the public record, even investors who do due diligence on their broker are not adequately protected.

These types of occurrences are not rare. An investor who contacts the OSC, the IDA or the MFDA about a particular broker may well be given limited information. The investor, only weeks later, could discover that the broker has been under investigation, jailed for fraud and/or the brokerage house suspended. In the meantime, the investor's funds could have disappeared.

THE CASE OF THOMSON KERNAGHAN

After a two-year sting operation known as "Bermuda Short", the FBI announced that the chairman of Canadian investment dealer Thomson Kernaghan was indicted for fraud. The IDA petitioned the Canadian Investor Protection Fund to place the brokerage firm into bankruptcy. Meanwhile, investors were still opening accounts at the firm even though other clients of the dealer had notified the Canadian regulators more than one year earlier about transgressions there.

In a recent case launched by a client of Thomson Kernaghan, the Ontario Court of Appeal maintained that the IDA "does not owe a duty of care and is not accountable to individual investors."[xi,xii]

The regulators' current policy of maintaining silence during an investigation protects the brokerage firms – not the investing public. This policy also hides the failure of a regulator to initiate a timely and thorough investigation and brings into serious question whose interests the regulators are protecting.

THE CASE OF RAMPART SECURITIES

An example of a Self Regulatory Organization (SRO) failing to act in a timely fashion on a member firm, Rampart Securities, was reported in Investment Executive Magazine. Paul Bourque, Senior Vice-President of Member Regulation of IDA, stated the following in their defense in this article:

> *"The conclusion that there has been a systemic failure to comply is arrived at from a pattern of behaviour, over time, that demonstrates an inability or unwillingness to live within the rules of the Association. The evidence of lack of compliance is incremental. It is not something that is demonstrated by isolated actions or activities."*

James Langton, the author of the article quickly pointed out the following:

> *" While the case appears to be well-timed to prove the IDA's mettle before regulators, it also indicates the sort of situations that were allowed to develop under its laissez-faire approach to regulation."* [xiii]

The following events occurred prior to the SRO suspending Rampart Securities:

- In August 1997 the firm's annual sales compliance review produced a list of problems requiring correction, including insufficient supervision.
- The firm opened 12,000 new clients with regulatory approval.
- In its 2000 compliance review, the IDA cited the firm for 17 new deficiencies, on top of 12 violations that had reoccurred between 1997 and 2000 including high levels of suitability issues, documentation problems and deficient financial compliance issues.
- In July 2001, the IDA permanently banned and fined a broker $110,000 for misappropriating share certificates from a client in 1997.
- On August 14, 2001, the IDA suspended Rampart's membership.

Recommendation

Public announcement should be made when a seller of financial products is under investigation, citing the reasons for that investigation. This would permit investors to make a more informed decision when considering whether to maintain or open an account with a prospective dealer. Any reprimands or warnings issued by SROs should also be made public.

6. Truth-Teller Protection

Since it is impossible for a regulator to identify all problems within the mutual fund industry, the legal process depends on insiders and sting operations to expose non-compliant activities.

Recommendation

Truth-teller (whistleblower) legislation, including employment protection, is required to protect informants.

7. Inadequate Mutual Fund Risk Disclosure

Mutual fund investor protection is challenged when prospectuses describe only general risks associated with investing in a fund. In other words, there are no warnings of specific risks, the impact of these risks or how often these risks may occur. Moreover, additional risks related to management, governance and insolvency are not identified.

Risks are also increased because according to a study prepared for the OSC-sponsored Investor Education Fund in 2002 most investors do not understand the literature that is provided by the industry.[xiv]

Recommendation

Investors must be given a standard prospectus in simple language prior to investing. The document should include all risks associated with the specific fund, the measures taken to mitigate them and their potential impact.

8. Questionable Sales Practices

An investment unsuitable to financial objectives is one of the most frequent complaints among investors.[xv] Many advisors, planners and brokers are not adhering to the Know Your Client (KYC) criteria required to make prudent investment recommendations – e.g. investor's age, risk profile, stage in life, tax position, asset base, etc. An advisor must match the risk exposure and return potential of the securities being recommended with the particular client's investment objectives and needs rather than a generalized notion of the average investor.

Recommendations

Advisors must keep and annually update a KYC form for every client – sometimes referred to as a New Account Application Form (NAAF) – for three purposes: to profile a client in order to provide appropriate advice; to bind the advisor to the needs of the client; and to make actionable advisor's recommendations that are clearly contrary to the interests of the profiled client.

A standardized purchase/switch fund checklist form that highlights key mutual fund characteristics such as fees, risks and advisor compensation should be made available and at the investor's option jointly signed by the client and salesperson. Both parties should retain a copy, as a reference point in case of disputes.

Undisclosed marketing arrangements that could encourage financial advisors to recommend one fund over another for personal/corporate gain should either be disclosed or prohibited.

Promotion of corporate sales and/or profits rather than serving the needs of the client should be subject to penalty.

9. Management Expense Ratios (MERs) Mask Rather Than Illuminate Costs

An April 1999 Angus Reid poll for the Canadian Securities Administrators found that 41% of investors had a poor understanding of MERs and 29 percent had a poor understanding of mutual fund sales charges.

This lack of transparency of costs can lead to bad investment decisions.

Fees and commissions to advisors are a huge component of management charges. However most investors are not aware that commissions are embedded in MERs and that the advisor is being paid by the fund company.

Recommendations

Investors should receive a description, accompanied by a graphic representation, of a breakdown of MER charges over for 1, 3, 5 and 10 year periods based on varying investment amounts. It should be specified that only the MER is reflected in the description, not RRSP fees, switch fees, transfer fees, brokerage expenses etc.

Some MER cost elements should be itemized for greater investor transparency, such as

• marketing and distribution fees (as is required by the U.S. Securities & Exchange Commission)

• disclosure of actual sales commissions and trailer commissions (continuing payments to salespersons as long as an investor stays invested in the fund) to identify potential conflicts of interest of advisors' recommendations.

10. No Governance Board of Directors

The establishment of independent mutual fund governance boards of directors is not mandatory, even though this is a necessary component for investor protection. A recent proposal by the Canadian Securities Administrators (CSAs), known as National Instrument 81-107, would place many currently prohibited conflicts of interest under the scrutiny of an Independent Review Committee (IRC). However, this Committee would have no authority to do anything more than make recommendations.[xvi]

Recommendations

Federal legislation should mandate that a governance Board of Directors must contain a majority of independent directors, including an independent chairman and investor. This board should at least deal with:

- Real or perceived conflicts of interest
- Internal controls
- Business practices
- Expenditures
- Financial statements approval
- Asset valuation methodology
- Evaluation of management performance

Board member compensation and the level of personal ownership within the funds should be disclosed. In addition, a fund company compliance officer should be required to report to the Board of Directors.

11. Negative Option Annual Reports

Exemptions to send Annual Reports to investors are granted by securities commissions. There is no law for them to be sent which places the responsibility on the investor to obtain them. This impedes ability to determine the merit of investments.

Recommendation

Federal legislation should mandate that mutual fund Annual Reports be issued to investors unless specifically declined by them.

12. Low Quality Annual Reports

Annual Reports and the associated financial statements are not easily understood by investors, nor do they always provide vital information such as:

- a return comparison to a designated performance benchmark
- a detailed description of fund operations
- insight on how well investment strategies are working
- a correlation of these strategies to existing and expected market conditions
- a detailed breakdown of fund costs and expenses

Recommendations

Annual Reports should include disclosure of all costs of a fund including marketing and distribution fees. They should provide a plain language summary of statistics describing the fund's volatility and sensitivity to market conditions as well as the impact of income taxes on fund returns. The current reporting of fund portfolio turnover percentage should be replaced by clearer measures such as the average time a stock is held within a mutual fund.

The Reports should also include the equivalent of a Management Discussion & Analysis to enable investors to better understand what actually happened to their money.

Financial reporting should be on a quarterly basis.

13. Poor Client Statements

Mutual fund statements provide limited information to clients about the performance of their investments. Moreover, statements are not understood by many investors. The practice of showing book value versus market value does not allow the investor to determine actual annual and cumulative returns.

Recommendations

There should be federal regulations to provide increased visibility of annual and cumulative returns on investments, costs (including cumulative fees paid to the mutual fund management company), risk and tax related issues. All investors should receive statements, clearly and simply indicating:

- Portfolio holdings with complete nomenclature/fund code
- Personalized rate of return per fund and entire portfolio
- Total cash invested compared to current market value
- Appropriate measure of portfolio risk
- Performance vs. funds' designated performance benchmark indices
- Personalized pre- and post –tax information

This will help investors determine how their mutual fund portfolio is performing and thus better plan for their retirement.

14. Low Advertising Standards

Misleading materials and brochures often encourage investors to buy new "hot" funds. This can lead to a significant shortfall when investors respond to short-term influences instead of sticking to long-term goals.

Recommendations

Federal regulations should force fund promoters to clearly display benchmark comparisons and fees. In addition, there should be a requirement to disclose the fund's worst 12-month performance in order for investors to appreciate volatility. This statistic should also be included in both the prospectus and Annual Reports.

15. Inadequate Disclosure of Information

Mutual funds do not disclose the extent to which fund managers own fund units, the basis on which they are compensated or how they vote their shares held by the fund. Mutual funds own millions of shares of Canadian companies. Some fund companies, their parents and Canadian banks also own wealth management, investment banking, brokerage, pension fund management, trust services and other financial services. This can create conflicts of interest between what is best for the client and what is best for the interests of the company and related parties.

Canadian regulations do not require mutual funds to disclose how and why the proxy shares were voted. This public disclosure by mutual funds is a key element of investor protection required by the U.S. Securities & Exchange Commission.

Disclosure of the results of voting would alleviate any suspicions about trying to placate management, obtain pension fund management business or support affiliated businesses.

Recommendations

Fund companies should be required to disclose:

- The level of ownership in fund units by the fund executives (insiders)
- The method and amount of compensation paid to the portfolio manager and key executives
- The proxy share voting policies of the fund and the actual voting results with accompanying rationale for the position taken

As part of its fiduciary responsibilities, mutual fund managers should adopt progressive proxy voting policies to build better-managed companies, reduce firm-specific risk, and yield stronger financial performance.

16. Financial Assault Via Educational Seminars

So-called "educational" seminars on financial/investment issues, especially those employing celebrity speakers, frequently encourage investors to make hasty and unsuitable investments.

Recommendations

Federal regulations should establish guidelines, restrictions and disclosure requirements for educational financial/investment seminars. In addition, investors must be given, and informed of, a "cooling-off" period of, for example, 15 days from receipt of the advisory in order to cancel the transaction without penalty.

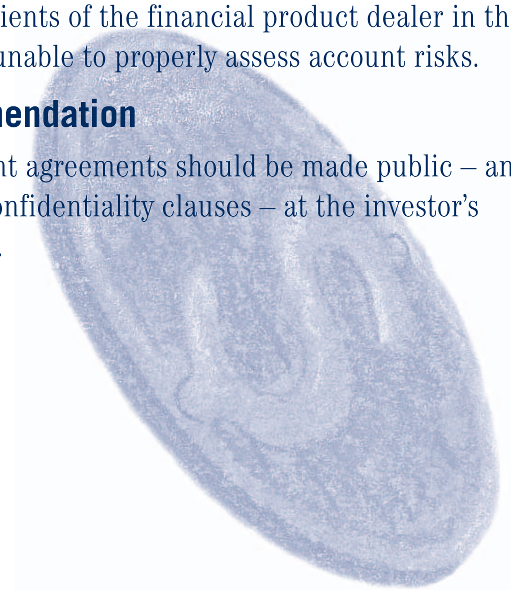
17. Settlement Agreements and Confidentiality Clauses

In cases of dispute between investors and firms, a settlement agreement is used to expedite closure and to avoid the costs associated with a potentially protracted legal action. Settlement agreements, often imposed on investors, may be detrimental to their best interests. Therefore, the current settlement process is unsatisfactory.

These settlements often contain a confidentiality clause which preclude investors from discussing their difficulty with anyone once the matter is settled. Therefore, it keeps all other potential and existing clients of the financial product dealer in the dark and unable to properly assess account risks.

Recommendation

Settlement agreements should be made public – and without confidentiality clauses – at the investor's discretion.



Case Studies

Case Study #1

In 1989, Jane, a single parent, having worked for 40 years (seven years from retirement), invested an initial $10,000 in mutual funds with a large brokerage firm. Over the next seven years, more funds were invested and, on the advice of her broker, she transferred her RRSP from her local bank to his brokerage firm. Jane believed that her investments were an extension of her 'bank savings account' and that they were safe and secure.

In 1995, Jane advised her broker that she wanted to use $100,000 from her account for a down payment on a condominium. He dissuaded her from buying it, saying that she had insufficient funds in her accounts to carry the mortgage. Furthermore, on the broker's advice, she invested even more funds.

On retirement in 1996, Jane decided to approach a mutual fund advisor of another investment company, as she was still eligible to invest in a RRSP. On reviewing her monthly statement, this advisor discovered that Jane's investment account had been wiped out and had been set up as a 'leverage account' – without her knowledge! During the period 1995-1999, $1.4 million had been "churned" in both investment and RRSP accounts. In spite of receiving a letter from Jane stating that no transactions were to take place without her knowledge or signature, monies still continued to be turned over, amounting to $85,000.

Who had provided signatures for the 150 leveraged investments?

Jane turned to the Ontario Securities Commission (OSC) to assist her in resolving this terrible situation. In 1999 the OSC forwarded her complaint and evidence to the Compliance Department of the investment firm.

Five years later, with legal fees, loss of interest and total losses amounting to $325,000, the Compliance Department offered her $62,500 including legal fees. The firm appeared to be unwilling to investigate the behavior of their broker or supervisor.

Since then, the broker has, in fact, been disciplined twice. However, he is being allowed to continue his activities. Meanwhile, the Investment Dealers Association is investigating two other brokers in the same branch.

Case Study #2

After a divorce settlement in 1998 and the selling of her home, Hannah had an investment account of $425,900 plus a RSP.

Both accounts were managed for a fee by a brokerage firm which went through several affiliations and changes of staff. By charting transactions, Hannah realized that her broker was not trading at the right time and in 1999-2000 her portfolio had lost on nine of 12 purchases. Although press reports had indicated that tech stocks were dangerous, the broker sold a group of them at the market peak. Moreover, he purchased more tech stock which promptly dropped. In September 2000 her account was at $532,000. A year later, it dropped to $352,700. To add insult to injury, Hannah received a huge tax bill!

Case Study #3

A broker forged Joe's name to withdraw some RRSP funds. He deposited the money with the bank where Joe already had a leverage loan. At retirement, on the recommendation of the broker, he not only withdrew his RRSP, but increased the loan to offset the withdrawal. The market then dropped.

To cover himself, the broker moved all Joe's cash into high tech stocks. Fortunately, Joe spotted this. He immediately moved his account to another firm, requesting histories of all accounts. What he received was indecipherable.

The deadline to sue the broker had already passed and Joe was left on his own to communicate with the provincial and federal governments about restoring his RRSPs. He did finally receive assistance from his bank's legal department and a new broker. The funds are now back in place, but at great expense. Joe lost approximately $50,000 not including the cost of lawyers and other expenses as well as the profit that his RRSP funds would normally have made.

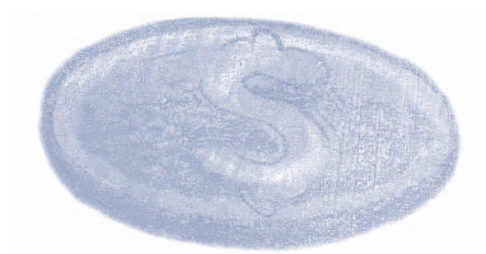
Joe reported his experience to the provincial securities authorities, bringing 10 charges against the broker. The broker lost his license for two consecutive months and was ordered to return to 'school', to pass tests and to pay all costs including fines totally $6800. He also received four reprimands.

There is now another case pending against this broker.

Case Study #4

In May 2000 Mario moved his entire portfolio of about $550,000 in RSPs and cash to a new broker. While he was out of the country, the broker traded without his permission pouring all of Mario's assets into high-risk technology and telecom stocks. One and a half years later, the account was reduced to $300,000. Mario then moved his account, now worth $215,000, to a new firm.

He also hired a law firm to sue the broker. However, there was a problem finding an expert who was willing to testify in court that the broker had, indeed, acted illegally. More than a year later, the case is still waiting to go to court. Meanwhile the broker continues to work – although his partner was fired for discretionary trading.



Appendix

USA Investor Protection

Recent revelations in the United States precipitated New York State Attorney General Eliot Spitzer to note that any regulatory system that relies on the industry it regulates for resources is unlikely to be able to provide unbiased investor protection:

> *"The major failure has been at the SRO level. Whether you are talking about research or mutual funds or specialist, there has been a failure to properly question behaviour that they know about before anyone else. Every one of those issues was understood by the industry and not responded to."* [xvii]

Mr. Spitzer reiterated this point to a group of students:

> *"Self-regulation has been an abysmal failure – an absolute, abject, complete zero. It has not done anything to protect investors."* [xviii]

In New York State, the Attorney General has used legislation commonly known as the Martin Act to intervene on behalf of investors. This Act is intended to protect the public from fraud by regulating sales of investment securities in the state and by requiring brokers, dealers, salesmen and investment advisors to register with the Attorney General's Office. An Investment Protection Bureau led by the former Assistant Attorney General was created to enforce this Act. Where appropriate, the Bureau's attorneys undertake investigations, criminal prosecutions and civil litigation on behalf of the investing public.

A federal regulatory system similar to the Securities and Exchange Commission (SEC) in the United States has been suggested for Canada.

i "Misconceptions still Exist in the Investment World", Angus Reid Group/Canadian Securities Administrators poll, 28 April 1999

ii Regulatory Burden Task Force, Report to the Ontario Securities Commission, December 2003

iii Investment Funds Institute of Canada, Industry Statistics, January 2004

iv "What Canadians pay for fund management", Morningstar Canada, 10 June 2003

v 12th Annual RBC/Ipsos-Reid poll, Wave I, 27 February 2003

vi MFDA Bulletin, #0056-C, 09 February 2004

vii "OSC Slams Fund Dealers", Registered Rep., 01 December 1997

viii "About the MFDA", MFDA web site, (http://www.mfda.ca/aboutmfda.html)

ix "Growing S.E.C. Role in Big Board Reform"; The New York Times, 25 September 2003

x "Scandal would kill market, OSC head says", Globe and Mail, 20 September 2002

xi Morgis, v. Thomson Kernaghan & Co., [2003] O.J. No. 2504 (C.A.)

xii "Investor takes IDA to court of appeals", Investment Executive Magazine, 03 October 2002

xiii J. Langton, "Rampart Case a test for new IDA," Investment Executive Magazine, September 2001

xiv Investor Education Fund, "The Focus on Financial Literacy", 22 April 2002

xv IDA Member Regulation Enforcement, 2003 Annual Report, 26 January 2004

xvi Proposed National Instrument 81-107, Independent Review Committee for Mutual Funds, prepared by the Canadian Securities Administrators, 09 January 2004

xvii "Self-regulating groups under pressure to change," Investment Executive Magazine, June 2003

xviii "On the warpath," New York Post, 25 January 2004

CARP is Canada's Association for the Fifty-Plus. A non-profit organization with 400,000 members in every province and territory, CARP's mission is to promote and protect the rights and quality of life for older Canadians. Its mandate is to develop practical recommendations for issues raised, such as poverty, health care and justice. CARP receives no operating funding from government in order to maintain independence. For further information on CARP actions and membership: **www.50plus.com./1-800-363-3697.**

The Small Investor Protection Association (SIPA) was founded in 1998 and incorporated in 1999 as a national non-profit organization. With members in nine provinces across the county, its mission is to aid public awareness of how the investment industry operates; 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. Many members of SIPA have experienced loss of savings due to wrongdoing by the investment industry. For more information: **www.sipa.to**