SIPA Sentinel

March 2005

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

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The SIPA Sentinel is issued bi-monthly. From time to time we include articles and re-prints that offer opinions on subjects related to investing and regulation. These are meant to help increase investor awareness, and SIPA may not share these opinions.

PETER J. THOMPSON / NATIONAL POST

IMET! Is this Canada's answer to Spitzer? In December 2003 the Wise Person's Committee said "It's time" to establish a national regulator. It is time for change. While being interviewed by Fred Langden and talking about IMET's very public actions, Joseph D'Cruz of the Rotman School of Management said "*This is a new era we're in. Corporate governance for banks is a completely new ball game*." Fred asked what will

the other banks think? D'Cruz replied, they will say "*Holy cow! This is a new ball game. This is not the way it used to be!*"
Well it is time that things are changed from the way they used to be. There appears to be the beginnings of a new resolve. The public is becoming aware. Industry listen up! RCMP Commissioner Zaccardelli said "*Trust is the bedrock of the civilized world*". It's time that the investment industry operates in a manner to warrant the public's trust … or lose it completely!

SPITZER SPEAK – from the Corporate Crime Reporter

Since Eliot Spitzer appeared on the scene the investment industry has been thrown into a tailspin. Spitzer has exposed corporate corruption and widespread wrongdoing. First he took on the Wall Street brokers, then the mutual funds, and then the insurance business. There is little doubt that corporate malfeasance is rampant in Canada as well as the United States. Industry and the regulators have failed investors and now Government must step in.
The Corporate Crime Reporter reports on New York Attorney General Eliot Spitzer's talk "Corporate Responsibility" at the National Press Club. CCR quotes Spitzer as saying "Teddy Roosevelt attacked the cartels, attacked illegal behavior, and he was reviled by business leadership".
CCR quotes Spitzer "what we have on one side is a business leadership that cloaks itself in the language of the free market, but really wants to preserve an ossified system, and they want to act against those who really support competition, transparency and integrity. On my side of the aisle … we have folks who really understand the market, who understand what it takes to permit the market to generate the wealth that has created this marvelous economy that we have and understand that government must step in every now and again to define the boundary lines and ensure that there is, indeed, integrity, transparency and fair play."

Mutual Funds & Market timing – from Macleans Magazine

Steve Maich writes about the $500 billion mutual fund industry in Macleans January, 2005 "Mutual misery - Though sales are up, mutual funds' glory days are over". Maich writes that net sales in 2004 were just over half what they were in 2001, when returns began to slide, and less than a third of the level in 1997, when Canadian funds pulled in a record $51.9 billion, and that, even after two solid years of stock market gains, Canadians yanked $3.7 billion out of equity funds -- those high-fee stock bundles that are the industry's staple.
Maich writes that none of this is a huge surprise to Glorianne Stromberg, a former member of the Ontario Securities Commission and a long-time advocate for the rights of small investors. The industry is suffering because of an inherent conflict of interest, she says. Fund companies make profits *from* their clients, not *along with* their clients.
Maich concludes the real significance of the market-timing controversy is that it points to a deeper problem of unethical behaviour in a business that's supposed to be based on trust. In 1995, Stromberg wrote a major report arguing for a long list of reforms,

including the creation of independent oversight boards to protect investors against abuses by fund managers. Those reforms have been locked in regulatory gridlock ever since.

Is this Investor Protection?

The government and regulators would have you believe that they provide investor protection. From the Ministers to the IDA, all will say investor protection is a priority of our regulatory system. They also admit that regulator's investor protection is preventative and not remedial. In plain English – they hope you don't lose your money but if you do they won't get it back for you. Is this investor protection?

Who is responsible for investor protection? Well, it depends on who is involved and what the product is. Most Canadians don't know.

With regard to securities, it is a provincial jurisdiction and so the Federal Government says the Provincial Government is responsible. The Provincial Government says the Finance Minister is responsible. The Finance Minister says the Ontario Securities Commission (OSC) is responsible. The OSC says their role in investor protection is preventative and not remedial, and delegate investor protection to the Investment Dealers Association (IDA). The IDA is funded by its industry members.

So how does the IDA protect investors? They develop rules. They expect their members to follow the rules. If they have cause to investigate because of an investor complaint, they may investigate to determine if the rules have been broken.

But does this help protect investors? Not in our opinion. There are too many examples of investors taking a complaint to the IDA, but the RR refutes the clients allegations and says he was instructed by the client. The regulators are aware that RRs revise KYCs to conform with the RRs activities, that RRs sign on behalf of clients, and that most clients do not know enough about their investments to instruct their advisor, yet often investigations are closed because the RR refutes the allegations.

Why do we need a national Investor Protection Agency?

A national authority is needed to look out for investors. The industry and regulators have proven incapable of providing real investor protection and therefore Government must step up to the plate and provide investor protection for all Canadians. Write your MP and demand an Investor Protection Agency as recommended in the CARP Report "Giving Small Investors a Fair Chance.

Truth and Justice - The Gomery Commission of Inquiry

Stephen Harper is quoted in the press as saying most of the Liberal politicians and Liberal-connected ad executives testifying at the Gomery hearings are lying. The press states Harper said most of the 67 witnesses heard so far by Justice John Gomery have failed to tell the truth to the commissioner about the operation of the now-defunct $250-million program, but felt confident that if Justice Gomery and his colleagues continue asking probing questions they will find the truth.

Although most Canadians believe in truth and honesty it is no longer unusual for people to lie to save their skin. A problem small investors face in dispute resolution is that their

opponents are quite willing to lie to avoid prosecution. That is why it takes a wise judge to mete out justice. He can't depend upon what he hears from blue suits who appear to be upstanding citizens. He must root out the truth from a web of lies.
The press also reports the government has launched a lawsuit aimed at recovering $40 million in sponsorship money. Eleven companies and eight individuals have been named in the statement of claim. Next Government must investigate the investment industry.

Larry Elford has an intimate knowledge of the investment industry. Prior to his recent retirement from the investment industry, Larry wrote investment columns for a local Lethbridge newspaper. Some of his articles did not sit well with others in the industry, but Larry felt compelled to speak out. The following article addresses the issue of industry lack of transparency, lack of disclosure and cover-up.

"CODE OF SILENCE"
Is it time to change Investment Advisor Behaviour?

By Larry Elford, CFP, CIM, FCSI, Associate Portfolio Manager, (retired)

There have always been written or unwritten rules dictating silence within the ranks of the investment industry. Employees experience threats of termination if anything is said that may embarrass the industry or the firm. But this raises a quandary. What does an industry member do when he or she witnesses client abuse, or code of ethics violations? What if management ignores, or worse, sanctions the behavior? What happens when the very people you are required to report to are part of the problem?

Larry is a retired investment industry veteran, who could not tolerate the industry code of silence and spoke against it. His input was not welcome, and he was constructively removed from his position.

Management compensation in the industry is partially determined by sales or revenues, which puts the industry in the position of walking the line between, acting as professionals to benefit the client and acting as salespersons to maximize revenues. These are two different horses, and both cannot be ridden at the same time by the same rider.

The industry code of silence is one of the largest impediments preventing the industry from becoming truly professional. It grew out of the days when investment dealers called themselves "stockbrokers", buying and selling shares. While many feel and act as if they are professional, the code of silence allows a few to act as financial predators hiding inside a business that runs on trust.

Today, the investment industry in Canada advertises the duty of care and trust to benefit the client. Are they delivering this duty to clients? When things go wrong, they

are often hidden by the industry's code of silence, or by confidentiality agreements purchased with clients' own funds. These allow the industry to talk the talk of trusted professionals possessing high levels of honesty and integrity while walking the walk of commission based salespeople. Need examples? They're easy to find.

Example #1: Free mutual fund trips. When *Globe & Mail* reporter Bud Jorgensen began writing articles about advisors sent on holiday junkets by mutual fund companies in (DATE), my manager announced that anyone who spoke to the press on the topic would be fired. At the time, he was about to enjoy his free annual trip to the Indy 500 courtesy of a fund company. After our entire industry was embarrassed by this kind of greed, the practice changed.

Example #2 - Double dipping. When advisors sell a fee-based account, clients are supposed to avoid commissions on subsequent transactions. I have witnessed several cases, however, where advisors have reversed the process for their own benefit. By investing a client's assets into a commission based account and later advising them to move to the new asset-based or fee-based account sets no compliance bells ringing. If the move results in no change except adding a new fee on top of the commissions already paid, the client has been double-dipped. It is unethical, but since it doubles an advisor's revenue and thus his income, it happens over and over.

Example #3 - "No duty of care owed to clients". Industry literature talks about the duty of care owed to the client, claiming, "Client interest comes first". It also specifies a clear duty of care and a fiduciary responsibility to a "professional standard". When 90-year-old Norah Cosgrove took her bank owned investment dealer to small claims court in Ontario for a $10,000 problem, however, the dealer's statement of defense was that "At no time were the defendants acting in a fiduciary capacity", and "The plaintiff was responsible for directing the course of investments in her account". To a 90-year-old client, they were claiming no duty, nor any responsibility. She was totally on her own. That is not what their advertising leads investors to believe. The largest and most supposedly trusted financial institution in the nation claimed they owed no duty of care for this type of account - exactly the same type of investment account held by the majority of Canadian investors. Will this defense be submitted if others run into a problem?

Example #4: Gag orders to cover up abuse or crime. When an investment firm is finally pushed into acknowledging wrong behaviour (usually after several years and many thousands of dollars in legal fees), they often offer to award the client cash to make the problem "go away". Part of this settlement process involves a confidentiality agreement requiring the client to promise never to reveal the facts of the case. Does this mean corporations in the financial/investment field can cover fraud or criminal acts by buying silence with the client's own money? It surely appears that way.

There was no disclosure when a 90-year-old Kelowna man lost his home to his trusted investment advisor, who helped the gentleman into an assisted living facility. Family members later found that the elderly client's home was transferred into the advisor's name at less than market value, without benefit of appraisal and at a zero interest rate. In order to get his home back, the client had to sign a release saying, "for value received ...". What value did the client receive for signing this document Answer: He received his OWN HOME back. For further evidence of the internal code of silence, consider that the IDA (Investment Dealers Association of Canada) was notified of this and were met with total non-co-operation by the firm involved. The company's code of ethics, by the way, states that, "every transaction or activity we are involved in must stand the test of complete and open public scrutiny". Some scrutiny. Some code.

Example #5: Hidden mutual fund commissions. Rather than the clear disclosure that the industry requires, much of the compensation paid to advisors by mutual funds remains hidden behind a legal prospectus. This might explain why a popular Deferred Service Charge (DSC) fund, which pays 5% to the advisor without disclosure on client confirmation or client statement, has grown over SEVENTY TIMES as large an identical fund that has no hidden commission structure. This growth was achieved despite a higher management cost to the client, and a multi-year penalty to the client to exit the fund. Which fund choice does your advisor suggest to you the DSC version, or non-DSC? Why? Where is the disclosure?

Example #6: employees forbidden to reveal commission-free funds. Although against both the spirit and intent of the Competition Act of Canada, as well as the written company policies, neither policy was followed at my company. Furthermore, I was told that the actual policy followed is *not* to inform the public that they can purchase mutual funds without commission. Since commissions were officially deregulated in about 1987, can you point to a single industry advertisement in which bank owned investment dealers showed the options available when purchasing a mutual fund?
Conditions will improve when legislators and judges forbid gag orders, codes of silence, and written or unwritten sanctions against people who speak out in the public interest. With almost daily revelations of investment scandals, corruption, and other evidence of corporate, "psychopathic" behaviour among some members of the industry, it is time to eliminate the dark corners that hide these abuses.
Until then, the claim that financial advisors qualify for the term "professional" will remain a painful and unfunny joke.

Written by a retired investment industry veteran, who could not tolerate the industry code of silence and spoke against it. His input was not welcome, however, and he was constructively removed from his position. Larry can be reached for comment at investoradvocate@shaw.ca or you can read more of Larry's writing on his newly published Blog site: www.investoradvocate.blogspot.com.

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Are leveraged investments appropriate for you?

By Stan Buell

All investors trust their advisors, and most trust the investment industry. That is the way it should be. The industry should be required to live up to that trust. Often industry fails investors and abuses their trust.

Many investors do not understand, nor do their advisors make them aware of, the risks associated with various types of investment products, and how these risks are increased with an investment strategy of leverage.

Most small investors are so busy earning a living and dealing with work and family issues that they do not have the time to become well informed about investments. Indeed, we are all encouraged to believe that we can depend upon the investment industry and investment advisors to look after our invested savings.

One of our top regulators said that the two professions most subject to fraud or wrongdoing are doctors (because they are too busy) and police (because they can't believe perpetrators would take advantage of them). The problem small investors face is that the investment industry rewards the registered representatives with commissions and bonuses based not upon how well their clients are served, but based upon the earnings they generate and the amount of accumulated assets under management.

Industry recognizes that assets under management can be greatly increased by encouraging investors to borrow money to invest. This provides a greater asset base on which to generate commissions and management fees. The strategy of leverage works well for the investment companies but often can cause extreme problems for small investors who do not understand the risks of this strategy.

There are three common elements in almost all cases of extreme loss: lack of diversification, unsuitable investment products, and leverage. Lack of diversification and unsuitable investment products certainly increase the investor's risk of loss, however when leverage is coupled with these factors the risk is magnified considerably.

A widow of modest means inherited $100,000. She had little investment experience and her modest savings were in G.I.C.'s. Upon receiving her inheritance she was encouraged to get financial advice. Her "financial advisor" (a mutual fund salesman) encouraged her to invest in mutual funds. Initially she purchased money market funds because she did not want to risk losing any of her money. As she gained faith in her "advisor" he encouraged her to invest in equity based mutual funds. She trusted him and followed his advice. Shortly after she agreed to buy these funds her "advisor", without her specific approval but relying upon the small print in the account opening agreement, unilaterally

arranged a loan for Margaret at the co-operating bank for $100,000 that was secured by the original $100,000 she had to invest. Some firms call this their 2 for 1 plan.

This arrangement was good for the "advisor". He had just doubled Margaret's assets under management, thus doubling the commissions and trailer fees this would generate, and enhancing his performance bonus. It was good for the company by increasing the assets under management and increasing the asset base for generating profit. It was good for the bank; the interest rate was not discounted, the loan was guaranteed by the investor's assets, and the mutual fund company had the power to sell out the investor whenever the value of the assets held would decline to 150% of the bank loan.

How did Margaret fare? Unfortunately for Margaret the value of her account declined. Within a few months the $200,000 investment was valued at $170,000. Although she was not a knowing investor she realized that she owed the bank $100,000, which meant that her original $100,000 was down to $70,000. She had lost more than $30,000 in one year. That was more than her annual salary and more than she could save in many years. Margaret called her "advisor" to say she did not like this and wanted out.

Then her "advisor" told her that if she cashed out there would be a redemption fee or deferred sales charge of 7% on the $200,000 worth of funds purchased or a total charge of $14,000. This would mean that Margaret's $100,000 inheritance would be reduced to $56,000 within one year. She had invested in mutual funds believing that she was not at risk. Now she faced a loss of 44% of her account in one year.

The strategy of leveraged investing in Margaret's case was disastrous. The investment was all in mutual funds. The funds were not appropriate. The effect of leverage magnified the losses. The redemption charges added to the loss.

Small investors should be wary of borrowing to invest. If you do not control your investments, the leverage strategy can cost you more than you would imagine.

SIPA Trivia

SIPA introduced its website in 1998. At first the website was an appendage to the site of a website developer who volunteered to host and operate the website. In 1999 SIPA obtained its own URL at www.sipa.to. In 2002 SIPA engaged a website designer, Ted Myerscough, to assist with redeveloping the website. The website incorporates a search mechanism for searching the website and provides numerous links to other websites.

Usage continues to increase. In 2003 the website averaged 11,970 hits per month. In 2004 this increased by over 50% to an average 18,019 hits per month. In February 2005 there were 20588 hits. SIPA plans improvements to its website later this year and invites suggestions from members as to how the website can be improved.