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Investor education and Protection

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Proposed Personal Financial Dealing amendments: Summary of nature and purpose of proposed Rule

http://docs.iiroc.ca/DisplayDocument.aspx?DocumentID=8AD422FA509D4584AD68A92BFED5E38A&Language=en

Kenmar Associates is an Ontario- based privately-funded organization focused on investment fund investor education via on-line research papers hosted at www.canadianfundwatch.com.Kenmar also publishes ***the Fund OBSERVER*** on a bi-weekly basis discussing investor protection issues primarily for investment fund investors. An affiliate, Kenmar Portfolio Analytics, assists, on a no-charge basis, abused investors and/or their counsel in filing investor complaints and restitution claims.

Kenmar agree that due to the extent and substantive nature of the proposed amendments, and the impact on investor protection, that they have been properly classified as Public Comment Rule proposals.

Kenmar is pleased to offer comments on the Investment Industry Regulatory Organization of Canada's ("**IIROC**") Request for Comments regarding IIROC's proposed amendments to rules related to personal Financial Dealing with clients. Appendix I provides some references we consulted in developing our position on this matter.

Our attention is focused on the rule regarding IR and RR's acting as trustees and executors for clients.

New rules relating to personal financial dealings between Reps and clients largely took effect in December 2013. This consultation involves proposed personal financial dealing amendments to clarify the rules, after, as is explained, dealers suggested that certain arrangements could be unintentionally captured in the existing rules, and that smaller dealers could be at a competitive disadvantage in certain circumstances. To address those concerns, IIROC is proposing amendments which aim to, among other things, clarify the types of dealings that should be captured by the rule. IIROC notes "*The proposed amendments have been designed to balance the investor's right to choose the individuals they appoint to manage their financial affairs with the need to protect investors from exposure to inappropriate conflict of interest situations,".*

As we understand it, the amendments would allow registered reps (RR's) and investment reps (IR's) to continue to act as a client's trustee or executor, subject to certain conditions and additional supervisory controls. The original rule banned Reps from serving as a trustee or executor. IIROC informs us that there was concern that this measure would take away a client's right to choose their advisor as their executor or trustee; and, that this benefits bank-owned dealers (with affiliated trust divisions) at the expense of smaller firms.

"Staff acknowledge the competitive impact this prohibition may have on some [dealers] and does not want to inappropriately restrict client freedom, however, the conflict- of- interest that such arrangements potentially give rise to must be dealt with".

IIROC is proposing amendments that would allow RRs and IRs to act as a trustee or executor for a client that is not a Related Person, provided that:

- the proposed appointment is disclosed to and pre-approved by the Dealer; (if approved, we recommend that the approval document be given to the client. Question: does this approval create a potential liability for the dealer?)
- the Dealer determines that any existing or potential conflict can be controlled by reassigning the responsibility to provide services to the client, including but not limited to assessing suitability, making investment recommendations and executing the client's trade instructions, to another RR or IR who is independent of the RR or IR who was appointed Executor or Trustee (the client should be told that this is the process that will be followed); and
- the Dealer has documented, management approved policies and procedures to supervise the account and the activities of the RR/IR who is exercising control or authority, to ensure any existing or potential conflicts of interest are addressed in a fair, equitable and transparent manner (we believe the best way to deal with conflicts-of-interest is to avoid them entirely).

The requirement to "assign another RR or IR to provide services to the client" is apparently not inconsistent with section 13.4 of the Companion Policy to National Instrument 31-103, which suggests that assignment to another RR or IR is one means of controlling conflicts of interests generally. In order for the Dealer to determine if the conflict- of -interest can be controlled by assigning the client's account to another RR or IR, the Dealer must assess the particular circumstances of each and every proposed arrangement in order to ensure that the new RR or IR exercises independent judgment and

will not be influenced by the original RR or IR who has assumed a control position over the client's financial affairs. This not an easy task and requires continuing monitoring, adding to the dealer regulatory burden without any economic benefit. Further, this will require significant effort even as a bevy of new securities regulations such as CRM2 and multiple new mutual fund rules are being implemented.

IIROC is also of the view that in order for Dealers to demonstrate that the new RR or IR is independent of the RR or IR who has assumed control or authority of the account, the account cannot be assigned in any of the following ways:

- to another RR or IR over whom the original RR or IR has supervisory authority;
- to another RR or IR that operates within the same sales team, or similar structure, as the original RR or IR; or
- to the sales assistant of the RR/IR who has been granted the position of authority.

The condition to have adequate policies and procedures and ensure that conflicts are addressed in a fair, equitable and transparent manner, are not apparently inconsistent with the requirements set out in the general Conflicts of Interest rule, IIROC Dealer Member Rule 42. We remain constructively critical of the efficacy of such independence assessments.[Question: Is IIROC suggesting that it would be acceptable for a Rep to act as an Executor even if the Rep is a Named Beneficiary in the will?}

Even if the independence is beyond question, once the Rep is an executor he/she can close the account and transfer the proceeds beyond the domain of the dealer. Thus, this protection mechanism is feeble and short term. In any event, the fees for fulfilling the role of Executor are not insignificant and in themselves thereby constitute a conflict-of-interest irrespective of whether or not the servicing of the client is or is not transferred.

If approved, the amendments would therefore allow Reps to continue to fill the trustee/executor roles, subject to the a/m conditions. IIROC opines that it believes this approach gives dealers and clients the flexibility to allow such arrangements, while also providing sufficient client protection. We feel otherwise ,especially after reading the 2013 IIROC Enforcement report ,particularly the section on seniors, a rapidly growing demographic. A recent IIAC report identified seniors as especially vulnerable to financial manipulation and abuse.

Our experience with personal financial dealings with clients has been uniformly negative.

First off, we note that Reps are licensed to effect investment transactions under a non-fiduciary relationship. The Executor has a fiduciary duty to act in the best interests of the deceased. The client trust that is apparently in place is based on incorrect knowledge of the true relationship, further confused by misleading Rep titles. The relationship is loaded with conflicts-of-interest. Further, the training and licensing of Reps does not include training to be a trustee/executor. The knowledge and skills and duties of being an executor are extensive. See **Being-an-Executor-2014** online http://www.publiclegaled.bc.ca/wp-content/uploads/2014/04/English-Being-an-Executor-2014_online.pdf

Fulfilling all the responsibilities of an Executor can be difficult and time-consuming. In many cases, an

estate will not be settled for many months or even years, during which time the Rep the client selected could spend hundreds of man-hours carefully working out all the details. It's crucial that the Rep Executor has the time to devote to settling the estate. The tasks involved can be very demanding - the executor may have to meet with many different experts, including lawyers and insurance agents during business hours. Clients should not want to impose these responsibilities on someone who will not be able to make the time available due to their own work load at the dealer or family responsibilities.

Before an investor names a Rep as an executor, they would need to be aware that if their Rep dies before the estate or trusts are wound up, the executor named in the Rep's will becomes their executor. We constantly remind investors that by appointing the individual person who happens to be a Rep; they're not appointing the investment dealer.

These facts and issues are not generally known by clients so any designation of a Rep as a trustee /executor would not be an informed decision. If this controversial Amendment were somehow approved, a plain language disclosure and risk acknowledgement document would have to be signed by the client with regulators knowing full well the limitations of such disclosure and self-risk affirmations.

We therefore question the wisdom of such a selection and why IIROC would want to introduce such a rule. The potential economic or other interests of non-bank affiliated dealers should not trump common sense and investor protection.

We would also like to point out that, although clients often want someone neutral in the role of executor, liability concerns have made it unattractive for Reps to take on this critical role. In our experience, where a trusted friend or family member is not available, the best choice is often a Trust company. With a Trust Company, those dealing with the estate will be less emotionally involved with the death and may be more objective in dealing with various family interests. In addition, trained and experienced staff will always be available to deal with issues as they arise and to work through the administration of the estate in a timely manner. Although trust companies charge for their services, the charges are set by provincial tariff, and any executor would be entitled to charge according to the same scale.

It seems to us that the upside of a Rep acting as executor for a client is very limited. Essentially if they're going to act as an executor, their role as a Rep is going to be curtailed .The account has to be transferred to another independent Rep without the client background knowledge, sensitivities and history. As an executor, a Rep wants to avoid an appearance of a conflict of interest, whether it's a real conflict of interest or a perceived one. This is an area where there are heartfelt emotions, and the chances of people taking umbrage in one way or another are unpredictable but frequent. We see no benefit for clients or Reps of such arrangements, only trouble. Quite frankly, the industry and IIROC runs a reputational risk if this controversial rule leads to some high profile debacles.

As we have pointed out, the duties and obligations of an executor are many and varied. The liabilities are numerous. If this amendment is approved, we argue that Reps must carry executor insurance. It is our understanding that there is a form of protection for executors on the market. ERAssure www.erassure.com offers errors and omissions insurance for executors of estates valued up to $5

million. An ERAssure policy provides coverage for a three-year term, which is the typical time frame required by most executors. We have been told that while executors can't purchase policies directly, lawyers can register with ERAssure and then apply for coverage for executor clients.

IIROC may also want to consult with provincial Offices of the Public Guardians to see what experiences they have encountered in taking over financial obligations previously entrusted to a investment Rep. While not directly an executor issue, many of the core issues are similar and some lessons may be learned.

For us, the bottom line is that this Amendment is not in the Public Interest.

One further point. We have stated on numerous occasions that consultations such as this one are fundamentally deficient in that the number of industry respondents far outnumbers those from the investor side. This can mislead IIROC. We therefore repeat our request that IIROC establish a funded Investor Advisory Panel to ensure the voice of Main Street is heard.

Kenmar Associates agree to public posting of this Comment Letter.

We would be pleased to discuss our comments and recommendations with you in more detail at your convenience.

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Respectfully,

Ken Kivenko P.Eng.
President, Kenmar Associates

APPENDIX I: Selected References

1 **Bridging the Trust Divide: The Financial Advisory-Client Relationship**
http://knowledge.wharton.upenn.edu/papers/download/ssga_advisor_trust_Report.pdf'

2... **Why-A-Fiduciary-Standard**
http://faircanada.ca/wp-content/uploads/2012/06/Why-A-Fiduciary-Standard_-Kivenko.pdf

3. **Intermediary Commissions and Kickbacks**
http://www.cepr.org/meets/wkcn/5/5567/papers/OttavianiFinal.pdf

4. Understanding the Incentives of Commissions Motivated Agents: Theory and Evidence from Indian Life Insurance http://www.centre-for-microfinance.org/wp-content/uploads/attachments/csy/1918/Life%20Insurance%20Agents.pdf

5. **Financial Advisors Encourage Bad Behavior**
http://www.forbes.com/sites/rickferri/2012/03/30/financial-advisors-encourage-bad-behavior/
The Market for Financial Advice: An Audit Study This working paper by Sendhil Mullainathan (Harvard), Markus Noeth (University of Hamburg), and Antoinette Schoar (MIT), was recently published by the National Bureau of Economic Research (NBER), a private, non-profit, non-partisan research organization. Most individual investors consult a financial advisor before purchasing investments. Given the central role of advisors in the investment process, Mullainathan, Noeth and Schoar tested whether financial advice serves to de- bias individual investors and thus correct mistakes they might make without these inputs, or whether advisors encourage the same bad behavior. The study defines 'good advice' as recommendations that move investors toward a low-cost, diversified index fund approach, which textbook analyses on mutual fund investing suggests. Overall, their findings suggest that the market for financial advice does not alter individual investor biases, and if anything may exaggerate existing biases. They also found that advisor self- interest plays an important role in generating recommendations that are not in the best interest of the clients. They are unwilling to lean against these biases even when they know they exist because not doing so helps them further their own economic interest.

6. **What is the Impact of Financial Advisors on Retirement Portfolio Choices and Outcomes?**http://www.smeal.psu.edu/csfm/PERS3_201110.pdf "Although we cannot conclude that those investing through a broker would have been better off investing on their own, our findings suggest that brokers are a costly and imperfect substitute for financial literacy..."

7. **Financial Advisor or financial salesperson?**
http://retirehappyblog.ca/financial-advisor-or-salesperson/ "One of the big challenges of the financial industry is that most compensation and profits are driven by the sale of financial products like mutual funds and RRSPs. Unfortunately for Canadians, most financial advisors do not get paid to do financial or retirement plans. In fact most financial advisors are not paid for advice. All of their plans and advice are "FREE"." The article lists some of the scare tactics used to get clients to invest more.

8. **Conflicts of interest in the financial industry** http://balancejunkie.com/conflicts-of-interest-financial-industry/ The author provides some examples of questionable advice coming from the financial industry because of conflicts of interest. Example: "Pay off debt or invest?: "Why won't my advisor sell Exchange Traded Funds? Jon and Irene have some friends that have decided to move out of their mutual funds and into Exchange Traded Funds (ETFs). ETFs are appealing because they are low cost investment products. Their friends showed them some compelling research showing how higher fees puts investors at a disadvantage. Why didn't their advisor suggest ETFs? Most ETFs are lower cost because they either have lower compensation or in most cases, NO compensation built in for the advisor. As a result advisors must either charge a transaction fee to get compensated or they have to charge a discretionary fee directly to the client. What's best for Jon and Irene really depends on the value provided by the advisor."

9. **90% SALES 10% ADVICE :A SNAPSHOT OF THE FINANCIAL PLANNING INDUSTRY**

http://www.industrysupernetwork.com/wp-content/uploads/2011/10/A-snapshot-of-the-financial-planning-industry-110930-1010version.pdf "The facts set forth in the report support the position long held by ISN that ongoing commissions and asset-based fees for advice enable planners and dealer groups to earn 'passive' income at the expense of consumers and should be banned, along with all other forms of conflicted remuneration. If ongoing asset-based fees are permitted to continue, credible reform requires that these fees be subject to a regular 'opt-in' mechanism. The ASIC [Australian Securities Commission] report has pulled back the curtain to reveal the extent to which the structure of the financial planning industry impedes planners from being able to act in the best interests of their client. The *Future of Financial Advice* reforms are essential to restructure this industry to serve the interests of clients, who are relying on advisers to help them save for retirement, build wealth, and otherwise manage their financial lives. However, the financial planning industry has stridently opposed the key aspects of reform legislation that would clean up their industry. The ASIC report makes this opposition easy to understand: this is an industry built around conflicted remuneration and passive income charged to millions of unwary clients (often from their compulsory super) who receive no ongoing services. "

10. **Financial Advisors: A Case of Babysitters?**
http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1360440&rec=1&srcabs=1009196&alg=1&pos=2
(2011) **Abstract:** We use two data sets, one from a large brokerage and another from a major bank, to ask: (i) whether financial advisors are more likely to be matched with poorer, uninformed investors or with richer and experienced investors; (ii) how advised accounts actually perform relative to self-managed accounts; (iii) whether the contribution of independent and bank advisors is similar. We find that advised accounts offer on average lower net returns and inferior risk-return tradeoffs (Sharpe ratios). Trading costs contribute to outcomes, as advised accounts feature higher turnover, consistent with commissions being the main source of advisor income. Results are robust to controlling for investor and local area characteristics. The results apply with stronger force to bank advisors than to independent financial advisors, consistent with greater limitations on bank advisory services.

11 **Duties of Disclosure**
http://www.lawgazette.com.sg/2003-6/June03-feature.htm

12. Probate-Executor Presentation-Summary-2012 CARP
http://www.carp.ca/wp-content/uploads/2012/03/Probate-Executor-Presentation-Summary-2012-1.pdf

13. **CBA British Columbia - role of an executor**
http://www.cbabc.org/For-the-Public/Dial-A-Law/Scripts/Wills-and-Estates/178.aspx

14. **Can I appoint my lawyer as my executor?:** Estate Law Canada:
http://estatelawcanada.blogspot.ca/2010/07/can-i-appoint-my-lawyer-as-my-executor.html