SIPA Sentinel

April 2009

SIPA's mission: To aid public awareness of how the investment industry operates, to provide guidance to those with an investment complaint, and to pursue improved investment industry regulation and enforcement.

Small Investor Protection Association - A voice for the small investor

SIPA SENTINEL

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

HOUSE OF COMMONS FINANCE COMMITTEE – SIPA PRESENTATION

In August 2008 SIPA made a submission to the HOC Finance Committee on behalf of Small Investors. We were invited to appear as a witness in Ottawa on March 31st. There were six witnesses so we had about five minutes each and then response to members' questions. The prior week we submitted an eight page document for translation into French and distribution to committee members so our presentation simply highlighted the items in our written submission.

HOUSE OF COMMONS STANDING COMMITTEE ON FINANCE
The Small Investor Protection Association - March 31, 2009

In August 2008 SIPA made a submission entitled *"Investor Protection Illusion"* to this Committee. The ABCP fiasco and the subsequent financial market meltdown are revealing financial fraud and wrongdoing of a scale that is hard to believe. The industry created structured investment vehicles to enhance the industry's take, and executive compensation spiraled ever higher while regulators failed to react.

The regulators claim to provide preventative investor protection but fail to prevent financial fiascos or systemic fraud and wrongdoing that are the direct cause of small investors losing their savings. The Canadian public is being misled by the financial services industry and the regulators who would have us believe that the investment industry is well regulated, and that investors can place their trust in the industry. Reliance upon the industry to self regulate and protect investors is an inherent conflict of interest and does not protect investors.
The industry creates innovative structured products to circumvent regulations that cannot keep up with the fertile minds developing new products. Regulators allow these practices and at times provide exemptive relief from regulations supposedly meant to protect investors. The CSA 2008 Enforcement Report states:

> *In 2008, $200,000 was ordered in Saskatchewan and Manitoba in restitution, $570,000 was paid out in Quebec and Manitoba in compensation, and $15,800,000 was ordered in B.C. and Ontario in disgorgement against respondents."*

That is, the regulators ordered or paid out a total of $770,000 to aggrieved investors in 2008, which is slightly more than David Wilson, Chair of the OSC, receives in annual salary, but $15,800,000 was paid to the regulators.

Canadians who lose their savings to investment fraud and wrongdoing need time to realize they have been victimized, and then to find their way through the maze of regulators who do not help. Victims will be condemned to finish their declining years without the fruits of their life's labour. Their lifestyle will be compromised and in many cases so will their health. Still worse, many will lose faith and hope, and contemplate suicide. SIPA recently received an e-mail:

> *"My parents, ages 81 and 76 … All of the money invested is lost. This was most of my parents' life savings … My father became depressed from losing all of his money. Coupled with the cancer that he had, this caused him to take his own life".*

Widespread practices of fraud and wrongdoing cost Canadians $20 billion per year. Forged signatures and false documents are not unusual. Selling unsuitable products and the use of inappropriate leverage is accepted practice. The creation of structured products to circumvent regulations, the lack of disclosure and use of creative accounting to mislead investors is rampant.

Industry tries to create an illusion that the industry is well regulated. The illusion is supported by regulators levying headline grabbing fines, but the fines may never be collected. Our submission quotes extensively from the Markarian decision because it illustrates reality. Honourable Jean-Pierre Senecal J.S.C wriites:

> *"In this case, the defendant's conduct was highly reprehensible."*

Registered representatives are given titles such as "Investment Advisor", "Financial Consultant" or "Vice President". This conveys a message to investors that suggests these sales people are qualified to act as advisors. However, they may simply be sellers of mutual or segregated funds seeking to generate commissions.
Also, industry creates *"innovative products"* with names that tend to deceive investors. A prime example is the *Principal Protected Note* or PPN where guarantees are only at maturity and returns may be cut or suspended.

The Ontario Bar Association says *"The justice system is not designed to provide justice … it is designed to resolve disputes."* The Laflamme decision shows victims take ten years to obtain justice but most seniors can not survive the ordeal. Laflamme died a few years after gaining a Supreme Court decision. The Longstaff case in British Columbia was dismissed because the judge found that an uneducated laborer who lost his savings did so because his advisor followed an accepted practice of a "Leverage Plan."

Other Issues impacting Canadians' Retirement Security include

- Excessive executive compensation. Nortel illustrates this issue by the current Nortel executives grab for bonuses while there are pension concerns.
- Exemption from regulations and the law. Many faulty products ahd exemptive relief and the ABCP solution exempted perpetrators from the law.
- Lack of Whistleblower legislation for all Canadians.
- Lack of special courts and judiciary to deal with white collar crime.
- Underfunded workplace pension plans and the possibility of taxpayers without pension plans paying for a bailout.

I believe the majority of Canadians are just and upright with a sound sense of morality and ethics. However regulatory failure has allowed fraud and wrongdoing to become rampant. The investment industry has exploited the situation by providing incentives to create fundamentally flawed products and strategies that are sold to unsuspecting investors. The investment industry is guilty of fostering an ideology that they are capable of self regulation. Events have proven they are not. There were alerts raised that the investment system was faulty, yet regulators failed to react. There is a lack of oversight and there is no Authority with a sole mandate to protect investors. Investors are left in the hands of the perpetrators of the various schemes developed to devour the savings of Canadians.

We can only hope that the financial meltdown has sufficiently raised awareness to create public outrage that will precipitate Government action to rein in an investment industry by revising legislation and regulation.

It is time for Government to act.

INVESTING - RRSP vs TFSA

Government has introduced a new Tax Free Savings Account (TSFA) this year. It should have been called a Tax Free Investment Account as it can hold the same investments as your RRSP or RRIF. For those who are unable to fully contribute to both plans, which is better for you will depend upon your particular circumstance.

The RRSP contribution is deductible from your taxable income. However, all your contributions and all of the gains in your RRSP are taxed as income when withdrawals are made, which is why the experts recommend equities should be held in a non-registered account to take advantage of the reduced taxes on capital gains and dividends, and hold interest bearing investments in an RRSP as interest is fully taxed as income. The RRSP is simply a tax deferral system, and any advantage will depend upon your tax rates and how many years you have to contribute. Whereas the TFSA contribution is not deductible from your taxable income but all your contributions and all your gains are free from tax when they are withdrawn.

Investors should be aware that you can transfer investments from any account to your TFSA and it is NOT necessary to deposit cash. So if you have an investment that has gone down in value you can transfer that to your TSFA and any recovery will be accumulated tax free. With the recent market meltdown it is an ideal time to transfer those investments to your TSFA. Be aware that a TFSA is NOT restricted to cash savings.

If your investments are fixed income there may be an advantage in contributing to your RRSP, but if your investments are equities there could be an advantage in contributing to your TFSA, if you anticipate the market will eventually recover, as all of the capital gains will be tax free. One of the main advantages of the TFSA is that all of the money in your TFSA is yours with no tax to be paid on withdrawal, and no requirement to convert to a RIF with mandatory withdrawals. Also withdrawals can re-deposited at a later date.

For those investors with RIFs who do not need the mandatory withdrawals, they can switch investments to a TFSA where any subsequent gains will accumulate tax free. This year the limit for TFSAs is $5000. You will need to review carefully your particular tax situation so that you can arrive at an appropriate investment decision.

LEVERAGED INVESTING

There are probably many investors that have suffered loss due to leveraged investments. Be aware that some advisors may be promoting leveraged investment because the markets have fallen so far, but there is no guarantee that markets will recover quickly. The risks associated with leveraged investments are always present. The cost of borrowing generally exceeds any gains that may be made with prudent investments. However these costs apply in all markets and whenever markets move sideways the value of your investments will be reduced by the cost of borrowing. When markets go down your investments will be decreased by not only the loss on investments but also the cost of borrowing. Unless you can afford the risk of loss and manage your own investments, you should be cautious about leveraged investment. We suggest that members and seniors avoid leveraged investment.

SIPA has been alerting investors about the dangers of leveraged investments for many years. We continue to be concerned about the practices of some advisors and some fund companies to encourage investors to borrow money to invest. In many cases retired persons and seniors have had sufficient savings, but when they invested on a leveraged basis, the significant losses resulted in unexpected hardship. Investors invested in mutual funds on a leveraged basis will have experienced a considerable drop in the value of their investments over the last couple of years.

We continue to believe that leverage is not a good strategy for anyone at or near retirement who does not have a continuing power to generate income. Leveraged investing can result in forced sale of investments during market downturns to meet margin requirements. This results in locked in losses and generally results in the inability to recover these losses.

We believe the comments in the SIPA Sentinel of March 2000 are still appropriate.

> *"Investing is a long term activity. Gambling is short term. Many people are turning to discount brokers and internet investing because of the difficulty in selecting a good financial advisor.*
> *However you decide to invest, remember that most of those who have had significant loss of their savings had their investments with one advisor, often in one product, and often leveraged.*
> *Diversification in your investing is a means of reducing the risk of extreme loss. This can mean investing in different products and also investing with more than one firm.*
> *Each investor will have different needs and different tolerance to risk. The first step is to understand what is most appropriate for you. A good financial advisor can help you to determine your profile.*
> *If you are approaching retirement, or already there, you must give serious consideration to capital preservation, and not expose your assets to an unacceptable risk level.*
> *Borrowing money to invest increases your risk. Any increase in value is reduced by the costs of borrowing. On the other hand the downside is magnified because the borrowing costs are added to the losses. Beware of leveraged investments.*
> *Take an interest in preserving your hard earned savings. Make sure you understand what is being done with your investments. It's your money!"*

THE COURTS DON'T ALWAYS HELP VICIMS

The recent financial meltdown has impacted many investors, particularly those who were invested in equities or equity base funds using leverage. Many investment dealers promote the use of margin accounts and "advisors" encourage clients to borrow to invest. Money from bank loans or home mortgages are often placed with investment firms and margin loans provide additional leverage. Some mutual funds regularly offer leverage and this magnifies the risk of investing, bearing in mind that the coast of borrowing generally exceeds the investment return on a risk free investment.

A recent decision on a civil case in British Columbia should alert all investors to the danger of leverage investing. An individual with a learning disability lost his father at age three and started work as a laborer at age 18. Initially he lived with his mother who provided guidance and looked after his mail even in later years. At age 21 began work with the City and 36 years later he retired with modest savings. When his mother dieD he inherited about $200,000 and his bank recommended he talk to a financial advisor. He ended up with leveraged investment in mutual funds and subsequently lost most of his savings (before the market meltdown).

This looks like an open and shut case as far as advisor liability is concerned, however the judge's decision is concerning. It must be born in mind that the judge's role is to interpret the law and not to mete out justice. The judge properly found that the advisor had a fiduciary duty, however, he dismissed the case because he felt the advisor had fulfilled his fiduciary duty and stated *"a professional person is not negligent if he is following a generally accepted practice."* To us it seems that not only were the products unsuitable for the investor, but the strategy of leverage for equity investments was most unsuitable for someone in that situation.

So, investors must be wary and avoid losing your savings. The chances of full recovery are slim indeed. The investment industry has the best lawyers, and are seemingly able to maneuver the justice system so that justice seems not to be done in many cases.

PROBLEMS WITH BUSINESS INCOME TRUSTS CONTINUE

The Financial Post reports that Precision Drilling Trust, a Calgary-based oil-and-gas well-servicing company, will cut its monthly cash distribution starting in March. The monthly unit holder payment of 4 cents per unit will be cut. The elimination of the payout comes after an initial cut to 4 cents from 13 cents last year. The price is down to less than $5.00 from about $28.

INVESTING REALITY

The current market meltdown has been a hard lesson for investors. Those who listened to "Advisors" recommending a strategy of borrowing to invest have probably suffered extreme loss, while those who failed to have a substantial portion in fixed income will also see their investments substantially reduced.

While it is probable the markets will recover, it is impossible to predict the time frame. Prudent investors may want to make some adjustment in their investment strategy. Many have been dumping their funds as they have experienced their savings evaporating, while those who focused on fixed income will not have suffered much loss.

Even dividend paying blue chip stocks have suffered steep declines in share price but until the dividends are cut, these may be worth holding. History shows that when dividends are cut there is usually a substantial drop in share price, however it is probable that Canadian banks, or at least most of them, will maintain their dividends as the share prices have already suffered substantial deterioration.

There are may offers of promised investment returns that seem too good to be true. Investors should be prudent and invest only with long established firms, and not chase after offered returns that are much above market rates.

PROTECT YOURSELF FROM PYRAMID SCHEMES AND SCAMS

Many investors have lost their savings when they gave their money to fraudsters. The Madoff Ponzi shows that even large investors can get burned. When investments which sound too good to be true are offered you should be circumspect and avoid committing any substantial portion of your savings unless you fully understand the details of the investment, the risks involved, and whether there is any protection against loss. In Canada the Canadian Investor Protection Fund guarantees cash investments with banks or other institutions that are members of the CIPF.

Many individuals invest without knowing the risk of substantial loss and whether or not there are any guarantees if bankruptcy occurs. If there are no guarantees your savings will be at risk. It is prudent to not risk more than about 15% of your savings in any one investment, no matter how good it may seem at the time. Many have lost substantial amounts with “legitimate investments” like Principal Protected Notes, Business Income Trusts or other structured products.

Other investors have lost with outright frauds and scams or ill conceived projects that were destined to fail. Real Estate Investment Projects, Pigeon Farming, and Multi Level Marketing are only a few of the many schemes designed to make the perpetrators rich at the expense of the investors.

FROM THE SIPA MAILBAG

In response to our request for input for the CBC program “Can You Trust Your Broker?” a member submitted the following:

“In November 2000 my (Mutual Fund Company) investment advisor suggested that I create an after tax portfolio, ostensibly to minimize my tax liability when withdrawing income from my RRIF. To this end he proposed a bank loan of $50,000, with the loan payments being deducted from my RRSP over a thirty-year period. I voiced my concern that perhaps the market conditions at the time were not conducive to be undertaking such a risky venture, especially using borrowed money. In reply, my investment advisor said he felt the market was close to bottom and that he had just taken a loan himself and invested in exactly the same funds he was proposing to me. I was still uncomfortable about the risk and proposed borrowing a lesser amount of $30,000 but

my advisor argued that a lesser amount would not be worth while. Reluctantly, I finally agreed to a compromise of $40,000.

In light of the market conditions at the time and the fact that I was using borrowed money, I stressed that the asset mix should be defensive and I was assured that it was but two years later it became obvious that this was not the case. Several of the funds my adviser had chosen turned out to be those with the greatest downside potential. The losses were further exacerbated by a minimal investment in fixed income – approximately 9%. As a result my investment loan portfolio lost heavily.

On several occasions over the next two years I expressed my overwhelming concern to my advisor and his supervisor about the continuing depletion of my savings caused by his strategy. In spite of my concerns I was advised against making any changes. I also made known my fear that the principal and interest payments, coupled with the unreasonable losses, were draining away any potential long term benefit that this strategy may have had but my concerns were consistently brushed aside. "Stay the course" was the only remedy I was given. Furthermore, my savings became doubly depleted. The money that had been taken from my RRIF to pay down the loan was for the most part money that has already taken a significant capital loss due to the sustained bear market. That money then took a further and greater loss in the investment loan funds. At the lowest point my losses in the various funds were 56%, 54%, 39% and 76%.

I was age sixty-two when the investment strategy was undertaken and it would seem from my own research that it made no sense for someone of that age to have been exposed to such risk and volatility. It took five years to recoup the cumulative losses incurred by my investment advisor, which I estimated to be $30,000, and as a result I was forced to put off fully enjoying my retirement years in order to make any significant recovery in the few growth years I had left.

Because of bad investment advice I sustained a financial loss, far worse than might have happened had I not been encouraged to take an investment loan. I took my complaint first to (Mutual Fund Company) Compliance Department then to OBSI. The entire process, which took over two years, was a humiliating farce with a foregone conclusion. Needless to say I am no longer with (Mutual Fund Company) nor will I ever trust an investment advisor again. Through my own prudent and conservative approach I have been able to make respectable gains over the last few years and I am even making money in the current environment."

SMILE: Reporters interviewing a 104-year-old woman: *"And what do you think is the best thing About being 104?"* the reporter asked. She simply replied, *"No peer pressure."*