SIPA Sentinel

May 2014

Small Investor Protection Association - A voice for small investors

The SIPA Sentinel is issued bi-monthly. From time to time articles and re-prints are included 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.

Starting with this issue each Sentinel will include voices of small investors. These are only fragments of the whole story to remind us what small investors face with the current regulatory system.

VOICES OF SMALL INVESTORS

> "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"
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> Source: e-mail received by SIPA

HOW TO MINIMIZE YOUR RISK OF BEING FINANCIALLY VICTIMIZED

Take time now to become aware of how the investment industry operates. INVESTOR BE AWARE that if you deal with a fraudster that is not registered with the regulators your chance of total loss is extremely high. Check the registration of your so-called "Advisor" with the Canadian Securities Administrators https://www.securities-administrators.c ... 1128#tools. Is he an Advising Representative (An Adviser) or a Dealing Representative (sales person)? The Dealing Representative uses titles such as Investment Advisor or Financial Advisor. Note that regulations for Advisers spell it with an "e". The industry uses Advisor with an "or" for their sales people to mislead the public and instill confidence. The top sales people will often gain the title of "Vice President".

If the person you deal with or one you are considering dealing with is not registered, immediately call the regulators to determine why he is not registered. To minimize risk to your financial health you should not deal with unregistered persons. Be aware that Earl Grey, recently released fraudster was not a registered person in any category but simply a super salesman who conned the public as well as his own family and friends.

O.K. after you have determined your current or proposed "Advisor" is registered either as an Adviser or Salesperson, you should next check with the regulators whether he has been disciplined already. Be aware that Insurance Companies and Banks sell products that are not considered securities (e.g. segregated funds are an insurance product) and therefore not regulated by Securities Administrators at least for non-security products. Such is the convoluted and confusing investment industry.

So once you get the all clear and your guy (or gal) is good to go. Be aware that disciplines normally follow errant behaviour by several years. One of our members many years ago had done his due diligence and found his "Advisor" was registered and had no history of discipline so he invested with him. To his surprise a few months later he read in the newspaper that his "Advisor" was convicted of fraud. At the time the investor checked him out with the regulators there was no indication given that he was already under investigation. The "Advisor" was Patrick Kinlin who was convicted and died in jail.

Be aware that the investment industry is self regulated and the perpetrators are given the benefit of doubt so there is no hint of wrongdoing for investors until the perpetrator is tried and convicted.

EARL JONES FRAUDSTER

Bertram Earl Jones is a Canadian fraudster who pleaded guilty to running a Ponzi scheme which, CBC News had reported, cost his victims "a conservative estimate of about $50 million taken between 1982 and 2009". After pleading guilty to two charges of fraud in 2010, he was sentenced to 11 years in prison. After serving only 4 years of his sentence, Jones was released on March 20, 2014.

Jones was born in Montreal on June 24, 1942, and was raised in the neighbourhood of Notre-Dame-de-Grâce. In his twenties, he worked at Montreal Trust Company, where he was trained in handling estate planning and wills. Beginning around 1979, he started his own investment advising business, though he did not register as a financial adviser with any securities regulator.

The Montreal Gazette reported that he promised Bernard Madoff-like returns to prospective clients. However, he never invested any of the $50 million he raised. He spent $13 million to finance a lavish lifestyle and paid back $37 million to maintain the illusion of the 8% return he had promised. The 158 victims included his brother and sister-in-law, who lost $1 million.

From July 9 to 26, 2009, he disappeared. CBC Radio One reported on July 16 that unless Jones returned, Quebec authorities would proceed with insolvency proceedings of his firm in his absence. On July 27, Jones surrendered to police. Earl Jones Consultant and Administration Corporation and Earl Jones, personally, were declared bankrupt on July 29 and August 19, 2009, respectively. The Trustee reported Earl Jones and his wife Maxine had acquired four properties during the fraud: a lakefront Dorval, Quebec, condominium, a condominium on a golf course in Mont Tremblant, Quebec, and two properties in the United States.

On December 3, 2009, CBC Radio One reported that his Dorval, Quebec condo was on sale for $950,000 as part of the bankruptcy proceedings to partially pay off creditors. All properties were eventually sold, the proceeds paying for the Trustee and legal services. In fact, the creditors would not recover any money through bankruptcy proceedings, as Jones had heavily mortgaged three of the properties to keep his Ponzi scheme afloat.

On January 14, 2010, Global TV Montreal reported that Jones admitted in court filings to having engaged in a Ponzi scheme for at least twenty years. On January 15, Jones pleaded guilty to two counts of fraud, and on February 15, he was sentenced to 11 years imprisonment. Throughout Jones' career he developed a vast network of professional and financial liaisons, which included lawyers and notaries, mortgage and insurance brokers, and banks. By his own admission, Jones was an unregistered financial advisor and relied on these business relationships to perpetrate his fraud.

At the Ponzi scheme's most basic level, Jones collected money from individuals and Estates and then returned the same money as monthly interest payments. Since there is a limited supply of new clients, the fraud could not have operated for as long as Jones perpetrated his scheme without what the forensic accountants have termed "fresh money". The so-called fresh money schemes required Jones to leverage the participation of his professional and financial relationships. Evidence produced in criminal and civil Courts indicates Jones obtained the vast majority of fresh money by fraudulently liquidating his clients' investment accounts and/or by coercing his clients to obtain mortgage loans on their homes, essentially placing their residence in jeopardy of foreclosure.

Earl Jones was NOT registered with the regulators. He had his own company also NOT registered.

SO WHAT IS THE NAME GAME?

You may or may not be aware of our comments about Advisor with an “O” and Adviser with an “E”. It seems not too many investors are aware of the significance of one letter. To provide you with a better basis for understanding you should check the CSA’s Understanding Registration, as it describes the different categories of registration and what they mean: https://www.securities-administrators.c ... ion_EN.pdf.

See for yourself and try to find “Financial Advisor” (spelled with an “O”). You won’t find it because they are registered as a “Dealing Representative”. However you will find an “Advising Representative”. Persons registered as an Advising Representative are qualified to give advice and act as an “Adviser” (spelled with an “E”). That is the significance of spelling with an “O” or an “E” in the eyes of the industry and its regulators.

On the other hand we believe this a deception that misleads the public into thinking their Advisor is really an Adviser and the word can be spelled either way. As a result many Canadians are falling prey to “Advisors” who are not competent to act as Advisers and are not required to look after your best interest.

We feel it is wrong for the regulators to allow the industry to practice this deception and further we feel that all firms and all individuals engaged in providing financial advice or selling financial productions should have a fiduciary duty and be required to look after their client’s best interests. After all financial futures and life savings depend upon prudent management of these funds to prevent financial disaster.

You should also view this video on YouTube by Larry Elford. It could save your financial future. https://www.youtube.com/watch?v=5ouEZoibNyY&feature=youtu.be

SMITH MANOEUVRE

Although the Smith Manouevre has been around for some time we first encountered victims of the Smith Manouevre this year. A book was written a decade ago describing how a residential mortgage can over time be converted to an investment loan. The reason for this is that in Canada unlike in the United States, the interest costs of a residential mortgage are not considered as a tax deduction against investment earnings whereas the interest costs of a loan taken out for investment is considered tax deductible against investment earnings.

The main issue with the Smith Manoeuvre is that it will only be successful if your investment earnings are greater than the interest costs of your debt plus any fees that you pay your advisor. It may involve a return of capital if investment earnings will not cover the interest. In this case your capital will be depleted.

On the canadianmortgagefunds.com website we see the following:

> ### Smith Manoeuvre
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> The Smith Manoeuvre is a technique that converts regular debt into tax-deductible debt. In the process, it affords the opportunity to pay off one's mortgage significantly faster.
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> The Smith Manoeuvre works basically as follows:
> - First find a “readvanceable mortgage”
> - Then sell your non-registered assets (like stocks held outside of an RRSP)
> - Use the proceeds as a down payment on your mortgage
> - Make your mortgage payments like normal

- As you pay off principal, re-borrow that principal into a line of credit (LOC)
- Invest this re-borrowed money at a higher rate of return than the interest you pay on the line of credit
- Deduct your investment loan (LOC) interest and use the tax savings (refund) to pre-pay your mortgage
- Repeat steps 3-7 until your mortgage is fully paid off.

Fraser Smith, for whom the Smith Manoeuvre is named, stated that the strategy can cut your mortgage payoff time in 1/2, while helping you invest more, sooner.

The Smith Manoeuvre is indeed a powerful strategy, but it's not for everyone. There are both investment risks and serious tax risks. Your returns could be insufficient, CRA could invalidate your application of the strategy, or you could wind up in a negative amortization scenario if your house value falls.

Implementing the Smith Manoeuvre takes more than just refinancing your mortgage and picking some mutual funds. Moreover, there is no off-the-shelf financial or income tax software that efficiently manages the process. The best advice is to get proper advice...from the start.

What are the risks of the Smith Manoeuvre?

Inevitably leveraged investing involves risk much greater than ordinary investment risk. The Ed Remple & Associates website provides a good assessment of the risks.

The long term growth and tax refunds are nice, but borrowing to invest is not for everyone. It is a risky strategy because you are borrowing to invest. It magnifies your gains and your losses a lot and can easily double or triple your profit or your loss. You owe the balance of the loan and the interest regardless of how your investments perform.

If you are the type of person that might panic and sell during a large market crash, then the Smith Manoeuvre is not right for you. If you do it for 30 years, there will likely be a few market crashes during that time and you need to be able to stay invested through them.
To consider this type of strategy, you need to be able to tolerate the ups and downs of your investments and stay invested for the long term, especially after any market crash and if the value of your investments falls below the amount you borrowed.

The biggest problem with borrowing to invest is that investors often do it at the worst possible time and not for the long term. Investors are often drawn to it after the stock markets have been rising strongly for several years. Stocks can feel safer, but this is the riskiest time to invest.

Be aware that marketing hype will emphasize the positive aspects of a particular investing strategy but will often not fully disclose the risks involved. For most investors, particularly those at or near retirement, it is not advisable to engage in leveraged investments. When the market is going up the leveraged investment goes up with the market less the cost of borrowing and fees. However, when the market goes down the leveraged investment goes down more quickly because the cost of borrowing and fees are added to the market loss.

The industry has many ways of encouraging investors to use leverage or borrowing to invest. It may be labeled as forced saving, leverage plan, buying on margin (in a margin account) or some other name. Unless you are knowledgeable and prepared to manage your investments yourself you would be well advised to avoid leveraged investment.

LEARNING GREEK and Why Not Learning Greek Could Cost You Plenty

The other day I tried to explain to someone why they should check their Advisor's registration. After explaining that many fraudsters were not even registered, so simply by checking for their registration, one can avoid dealing with non-registered fraudsters, and avoid the 100% risk of losing your savings.

I explained that even registered representatives also commit fraud and wrongdoing, and are sometimes disciplined by the regulators. By checking your advisors registration, you can also check their discipline history. This tends to reveal behaviour so those disciplined persons also should be avoided.

Then I explained that most "Financial Advisors" are registered as a "Dealing Representative" (Sales Person) and are not qualified to give financial advice. Worse yet they are not required to look after their clients' best interests. They are quite simply a salesperson selling financial products for a commission.

Further, I also explained that there is a registration class of "Advising Representative", and this person is qualified to act as an Adviser to give investment advice, and he does have a requirement to look after his clients' best interests.

Lastly, I explained that I felt the public was being deceived by the Name Game of using Advisor with an "O" to differentiate from an Adviser with an "E" and evade the regulations for a registered Adviser.

To this all too brief explanation of why it's necessary to check your Advisor's registration, I received the reply "It's all Greek to me."

Well, it's not surprising. That's the reason why so many Canadians are losing their savings … they blindly trust their Advisor because they are led to believe they can and believe he will look after their best interests.

Sadly, when a problem develops and the investor loses his savings he encounters stiff resistance to recovering his losses because the Sales Person called Financial Advisor has very limited responsibility.

One of the dirtiest tricks played by the industry is when the Advisor says you don’t have to worry about what to invest in because I will look after your account and buy what I think is suitable for you and sell it at the appropriate time. You may think that is great, and that you have a discretionary account that your Advisor manages.

Now there are discretionary accounts and these are managed by an Adviser or Portfolio Manager but he is registered as an “Advising Representative”. To open such a discretionary account there is additional formwork to be completed and the account is assigned to a portfolio manager.

But if your Advisor is not a portfolio manager and you ask for a discretionary account he will likely manage it for you on a discretionary basis. However, if things go terribly wrong as they may do, the firm will not accept responsibility for a discretionary account because there is no paperwork.

It is my experience over fifteen years talking to victims that is only those Canadians who have lost their savings that finally decide it's time to learn Greek.

THE IMPORTANCE OF FIDUCIARY DUTY

In Canada the responsibilities imposed by “fiduciary duty” and “duty of care” are vastly different. Although most investors believe their “Advisor” has a fiduciary duty to them, and we absolutely agree, the industry has the opinion that fiduciary duty applies only to managed or discretionary accounts.

On March 25, FAIR Canada and the Hennick Centre for Business and Law hosted the first Canadian conference focused on the fiduciary standard in the context of the financial advisor-client relationship. At the conference, the question of whether investment advisors should be required to put their clients' best interests first was considered in the context of the US proposal to implement a uniform fiduciary standard for all advisors and broker-dealers.

We attended the conference and had the opportunity to speak with other participants. While many feel there should be a fiduciary standard, not surprisingly the law tends to support the industry’s attitude and interpretation. Unfortunately there is widespread industry practice of “Advisors” telling their clients that the “Advisor” will look after their account and manage it for them so they “don’t have to worry about it.” However, to create a managed or discretionary account there are forms that must be completed as there is added responsibility for the firm and only certain individuals are qualified to manage a discretionary account. Most "advisors" are not qualified to do so and so if they were to complete the necessary paperwork they would lose this client’s commissions. As the industry “advisors” are commission driven, this is a powerful incentive for them to not complete the paperwork.

As a result many investors who believe they have a discretionary account find out when things go terribly wrong that the firm will not accept responsibility because there is not sufficient evidence (no completed forms) of a discretionary account. If you think you have a discretionary account ask the firm for a copy of the necessary forms for your discretionary account.

Client Statements Can Be Misleading

April, a SIPA member for some years, asked if we would look at her statement. She said it showed a 24% return for the last year and she was invested in mutual funds. As this seemed highly improbable we agreed to review her statement with her. From previous conversations we believed she had adequate knowledge but during our discussion we realized that many investors do not understand the significance of annualized rates of return. This means simply the rate of return for one year. It is important to know the annual rate of return, or yearly rate, so it can be compared to a benchmark. You can use as a benchmark: the annual rate of return of Canada bonds, or the annual rate of return on the stock market. If you own mutual funds that contain equities (or shares) the S&P/TSX index is a good benchmark.

It was not surprising to see that indeed April's statement from a fund company indicated a return of 24%. She had inherited some money which she invested in five different funds. Some of these had been turned over a year or so ago. The return was for her account but it was not an annualized rate of return it was the total return from inception. As she had opened her account 12 years previously, her investments were for a period of 12 years. So the annualized rate of return was close to 2% per year.

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

Bill 157, Financial Advisors Act, 2014

INVESTOR BE AWARE that a Private Member's Bill has been introduced in the legislature that appears to be heavily influenced by the investment industry. It is an attempt to have Financial Advisors legislated to provide legitimacy to the title Financial Advisor. Currently Financial Advisors are registered as "dealing representative – sales person" without fiduciary duty or requirement to look after client's best interests.

At the same time there is a classification Advising Representative for persons qualified to act as advisers.

And that is the importance of whether a representative spells Adviser with an "E" or an "O". Although dictionaries may provide both spelling variations as the same meaning, investment regulations are quite specific. It is amazing that the regulators allow the industry to mislead the public in this manner.

Now an act to regulate Advisors would be a good thing if it also defined the Advisors responsibility to be fiduciary in nature, but it does not. You can read the proposed Act on the following website:
http://www.ontla.on.ca/web/bills/bills_detail.do?locale=en&Intranet=&BillID=2934

We believe it is fundamentally important that the investment industry should disclose the truth and not try to mislead the public with false information. It is not enough to claim that regulating Advisors is good for investor protection. Simply registering an Advisor as such does nothing to protect investors.

To be effective any Legislative Act to regulate any profession must indicate the accountability and who is responsible for the administration of the Act. Self regulation of the investment industry has proven to be ineffective in providing investor protection. It is not enough to say it is preventative in nature as it is today. It must also be remedial. Self Regulatory Organizations (SRO) do not protect investors.

The province of Quebec is light years ahead of the rest of Canada with their Autorité des marchés financiers*(AMF).* The AMF is unique by virtue of its integrated regulation of the Québec financial sector There is no way Quebec would or should agree to a national regulator that only regulates securities dealers and mutual fund companies. This is only one of the reasons why it is improbable that Canada will not have a national regulator in the forseeable future. That coupled with the fact that banks and insurance companies have their own federal regulators and are able to develop financial products that appear to Canadians quite similar to a security. Such are the complexities of the regulatory system.

HAVE A COMPLAINT ABOUT MUTUAL FUNDS?

The Mutual Fund Dealers Association (MFDA) is the Self Regulatory Organization for Mutual Fund Dealers. They publish a good outline for pursuing a complaint with provincial variations. However don't wait for a reply from your dealer, but immediately contact the MFDA. Be aware the Limitation Period is only two years.

If You Have a Complaint:

1. Contact your Mutual Fund Dealer. Member firms are responsible to you, the investor, for monitoring the actions of their representatives to ensure that they are in compliance with the by-laws, rules and policies governing their activities. The Member will investigate any complaint that you initiate

and respond back to you with the results of their investigation in a timely manner, usually within three months of receipt of the complaint. It is helpful if your complaint is in writing.

2. Contact the MFDA. You may call our complaints area at 416-361-6332 or toll-free at 1-888-466-6332 or write to us using the complaint form available on our website. You may contact us by e-mail at complaints@mfda.ca, by fax at 416-361-9073 or by regular mail.
3. Contact the Ombudsman for Banking Services and Investments. Information regarding the Ombudsman follows.
4. Consider contacting a lawyer. A lawyer may be able to assist you with your complaint. Information regarding applicable limitation periods for commencing a civil action is set out below.
5. If you live in Manitoba, New Brunswick or Saskatchewan: Securities regulatory authorities in these provinces have the power to, in appropriate cases, order that a person or company that has contravened securities laws in their province pay compensation to a claimant. The claimant is then able to enforce such an order as if it were a judgment of the superior court in that province. Consult the website of your provincial securities commission for more information.
6. If you live in Québec: The Autorité des marchés financiers ("AMF") pays indemnities to victims of fraud, fraudulent tactics or embezzlement where those responsible are individuals or firms authorized to practice under the legislation governing the provision of financial services in Quebec. It also rules on the eligibility of claims and sets the amount of the indemnities to be paid to victims. Consumers can thus be compensated to a maximum of $200,000 per claim, through funds accumulated in a financial services compensation fund. Consult the AMF's website for more information.

Ombudsman for Banking Services and Investments

The Ombudsman for Banking Services and Investments ("OBSI") is an organization independent of government, the financial services industry and the MFDA. It investigates unresolved complaints from individuals and small businesses about financial services firms.

After the dealer's Compliance Department has responded to your complaint, you may contact the Ombudsman for Banking Services and Investments. You may also contact OBSI if the dealer's Compliance Department has not responded within 90 days of the date you complained. OBSI provides an independent and impartial process for the investigation and resolution of complaints about the provision of financial services to clients. OBSI can make a non-binding recommendation that your firm compensate you (up to $350,000) if it determines that you have been treated unfairly, taking into account the criteria of good financial services and business practice, relevant codes of practice or conduct, industry regulation and the law. The OBSI process is free of charge and is confidential. OBSI can be contacted by telephone in Toronto at (416) 287-2877, or toll free at 1-888-451-4519, or by e-mail at ombudsman@obsi.ca.

Limitation Periods

You may consider retaining a lawyer to assist with the complaint. You should be aware that there are legal time limits for taking civil action. A lawyer can advise you of your options and recourses. Once the applicable limitation period expires, you may lose rights to pursue some claims.

For further information regarding limitation periods in your province/territory, contact a lawyer or your provincial/territorial government.

Remember you can contact the MFDA if you have questions about making a complaint or to discuss alternatives at 416-361-6332 or toll-free at 1-888-466-6332.