

# CARP Submission to the Ontario Government Expert Committee to Consider Financial Advisory & Financial Planning Policy Alternatives



## Retail investors are at a disadvantage

The current investment system in Ontario often puts common retail investors at a disadvantage. Due to the complexity of financial products and information, investors trust and rely on financial advisory professionals for guidance and expertise. Investors assume that the industry is as well-regulated as other professions, that their interests are protected, and that they have recourse if there is misconduct.

This expectation is at odds with reality. In a survey of CARP members, the majority of those polled said that they believe financial advisors stand to lose their jobs if found to have acted against their clients' interests. However, no regulatory regime currently guarantees this result; in particular, financial advisors are not legally required to put their clients' interests ahead of their own. A client who suffers a loss must first go to court to prove that the advisor owed the client a duty of trust. No other recourse is available to recover the client's investment. Suffering financial and investment losses is difficult for all investors, but it can be especially devastating to older investors near or in retirement, for whom such losses are often irretrievable.

Professionals in the financial planning, advice, and services industries are currently not regulated by a general legal framework, as the consultation document notes. This lack of a general legal framework reduces accountability to and recourse for retail investors who have suffered losses due to inappropriate advice or other professional misconduct. Adding to this problem, the multitude of professional titles and designations within the financial advisory industry add further confusion to the process of retail investing. Retail investors are currently expected to wade through dozens of professional designations before choosing with whom to work and to what financial end, without the assurance that their best interest will be protected.

Increasing education, training, proficiency, and ethics requirements may further help to protect retail investors. Increasing licensing and registration requirements may likewise increase accountability and transparency, as would a central public registry that would allow retail investors to better assess prospective advisors. However, these and similar measures proposed in the consultation document and by many experts in the financial advisory industry, including calls for greater investor education, cannot adequately correct the imbalance between investor and financial professional.

Most importantly, none of these measures will help retail investors seek and obtain financial restitution if they were provided with inappropriate investment advice or suffered losses due to an advisor's conflict of interest. All financial advisory professionals should be bound to an enforceable, legislated fiduciary duty, as is the case for other regulated professions, such as doctors, accountants, and lawyers.

### **CARP calls for legislated fiduciary duty**

To truly level the playing field between retail investors and the financial advisory industry, CARP is calling for a legislated fiduciary duty both to balance the ongoing relationship between financial professionals and investors and to improve access to restitution.

CARP is calling for legislated standards that will bridge the gap between the average retail investor and the financial advisory industry, starting with a legislated fiduciary duty. A legislated fiduciary duty will help give investors an opportunity to save for their retirement both adequately and fairly by giving investors more protection from conflicts of interest, misconduct, and fraud. A legislated fiduciary duty sets a standard that, when enforced, can influence the behaviour of financial advisors so that they are more likely to act in the investor's best interest. As demonstrated in the case of Octagon Capital, the investor still has no right to financial restitution without going to court, even when the existing regulatory and self-regulatory bodies have ruled against the advisor. Therefore, a legislated fiduciary duty will also give investors access to restitution by providing them the legal framework and resources to pursue their cases and sue advisors.

### **The need for a legislated fiduciary duty in Ontario**

Many Ontarians rely on professional investment advice for financial planning. Saving for retirement is often the average retail investor's chief goal, but one which increasingly presents a challenge for most Canadians. Statistics Canada reported in 2011 that only 4.5 percent of total RRSP contribution room was used, a substantial decrease from 2010.<sup>i</sup> Canadians now leave over \$738 billion dollars of RRSP contribution room untouched, representing a lost opportunity for both individuals and the financial industry.<sup>ii</sup> Approximately 70 percent of pre-retirees, according to the Canadian Institute of Actuaries, are concerned about "maintaining a reasonable standard of living for the rest of their life" and almost half admit to being unprepared for retirement.<sup>iii</sup>

It is no surprise that retail investors are overwhelmed and reluctant to invest. In addition to recent economic turmoil and investment losses suffered in 2008, Canadians are losing trust in financial professionals. One third of CARP members have suffered a loss from an investment that was personally unsuitable.<sup>iv</sup> The vast majority of CARP members who suffered such losses claim that their advisor encouraged inappropriate investment, even though most invest conservatively and pride themselves on their financial knowledge and investing acumen.<sup>v</sup> A substantial minority of CARP members think most financial fraud originates with financial advisors.<sup>vi</sup> Almost 40 percent of CARP members polled think that it is common for a financial professional to mislead or defraud investors.<sup>vii</sup>

## Poor investor knowledge

Canadians' investment and financial literacy is very low. A recent study of Quebec and Ontario investors' knowledge found that there are "significant gaps" in investor knowledge of risk and return of asset categories, and that the general level of investor knowledge is "mediocre."<sup>viii</sup> The study notes that this "mediocre knowledge of the performance of categories and of the concept of risk premium calls into question investors' financial planning ability."<sup>ix</sup> Investors fail to understand a number of significant aspects of sound financial investment, according to the findings of the study:<sup>x</sup>

- The majority of investors underestimate the risks associated with shareholding
- The majority of investors believe there is no systematic risk-return relationship
- Almost all investors believe that some stocks offer a high return with low risk
- A significant number of investors do not sufficiently understand portfolio diversification
- 35 percent of investors do not know how to diversify
- 20 percent of investors don't know that stock portfolios can be diversified with mutual funds
- 20 percent of investors know there are no reliable means of detecting overvalued or undervalued stocks
- Half of investors largely overestimate the probability of obtaining an exceptional return when they invest in a company on the TSX Venture Exchange

This lack of knowledge renders them vulnerable to inappropriate advice and even investment fraud.<sup>xi xii</sup> Along with inadequate financial and investment knowledge, investors are generally unable to distinguish between professional designations and unaware of whether there is adequate protection and regulation in place. CARP's poll revealed that 64 percent do not know which professional designations provide the most protection to investors, and almost half do not know which agency has responsibility for regulating financial advisors.<sup>xiii</sup>

Many Ontarians are unlikely, therefore, to have the knowledge required to make sound financial and investment decisions on their own behalf. Financial and investment professionals play a crucial role in guiding investor decisions. But the low level of financial literacy which makes it difficult for average investors to make good financial decisions means there is an inherent imbalance of knowledge and information in the relationship between financial professionals and retail investors.

A legislated fiduciary duty can help level the playing field for financial advisors and investors. There is now an asymmetry of information, with advisors having much more financial knowledge and expertise than their clients. The fiduciary duty recognizes that imbalance and requires the advisor to exercise knowledge in the best interests of the clients, even ahead of the advisor's own interest.

Financial education efforts are helpful but they cannot be reasonably expected to sufficiently absolve advisors of their responsibility. Indeed, the focus of court decisions has been on this gap in knowledge and the degree of reliance that the client had on the advisor, thereby giving rise to a fiduciary duty and ultimately damages for giving advice that the advisor knew to be inappropriate for the client. A legislated fiduciary duty will impose that responsibility on financial advisors, and require them to provide the best advice based on their expertise and act in the best interest of their clients.

### **A legislated fiduciary duty will help will set a standard, clarifying the client-advisor relationship**

The playing field is further imbalanced by the amount of influence advisors have over investor's financial decisions due to the level of trust, discretion, and access that investors give to their advisors. According to Canadian Securities Administrators (CSA) 2012 Index survey results, increasingly more Canadians have financial advisors and most feel comfortable raising concerns and questions with their advisors. Furthermore, 60 percent of those with financial advisors have not done a background check of their financial advisors, which demonstrates how deeply investors trust their advisors.<sup>xiv</sup>

A study by the Investor Education Fund found that investors' trust in their advisors' opinions dominate all other factors in their investment decisions.<sup>xv</sup> Some even give their advisors in good faith a certain amount of discretion over the management of their investments, believing that their financial advisor will act in their best interest. However, advisors are not legally required to act in their clients' best interest. Current industry rules and codes of conduct set out a suitability requirement mandating that advisors know their clients for the purpose of providing suitable investment options. However, the suitability requirement leaves opportunities for conflicts of interest and does not necessarily serve the best interest of the clients.

A legislated fiduciary duty will set a standard of accountability for the position of influence, trust, and discretion advisors receive from their clients. It will ensure investors receive the professional service they expect from their financial advisors. The Ontario Court determined that if vulnerability, trust, reliance, discretion, and professional rules or codes of conducts are present, the client-advisor relationship is considered to be a fiduciary relationship.<sup>xvi</sup>

Given the degree to which advisors influence their clients' financial decisions, the financial advice industry should be governed by a fiduciary standard, as is the case for regulated professions, such as doctors, engineers, and lawyers. According to CARP's poll, 97percent of members believe financial advisors should be regulated like lawyers and accountants so that those who breach their professional standards are no longer allowed to practice.<sup>xvii</sup>

It is clear there are major gaps in investor behaviour and understanding. A legislated fiduciary duty would help to fill these by upholding financial advisors as trustworthy, neutral allies and clarifying the client-advisor relationship as a fiduciary one, in which advisors are responsible for prioritizing their clients' interests.

## **A legislated fiduciary duty will establish effective means of restitution**

A legislated fiduciary duty will establish better means of restitution. Currently, people must seek restitution through various complaint mechanisms and, eventually, the courts. This is an onerous process, and many investors do not possess the resources to pursue legal action. Furthermore, there is usually a limit on the compensation amount recommended by complaints bodies, regardless of the size of the financial loss.

For example, the Ombudsman of Banking Services and Investments (OBSI) takes complaints and makes resolution recommendations to financial institutions, but has no power to enforce compliance with its recommendations. Even if a compensation recommendation is made, the amount is limited to \$350,000. Investors can pursue their complaints further in court, but limitations and costs deter many from pursuing this route. For example, small claims courts are less costly and time-consuming, but only allow plaintiffs to claim up to \$25,000. The Superior Court of Justice, on the other hand, has no limit on the amount claimed, but the litigation costs are prohibitive.<sup>xviii</sup>

A legislated fiduciary duty removes one major uncertainty from the litigation and improves the chances of the client securing some restitution. The greater impact, however, may be that the existence of a legislated duty and greater chance of success in court will influence the behaviour and standards of advisors and their firms, both reducing losses and encouraging out-of-court settlements.

## **Ultimately, legislated fiduciary duty will help people to save adequately and fairly for retirement**

Everyone wants financial security in retirement. However, the aftermath of the financial crisis, the proliferation of financial professional designations, and increasingly complex investment products have made retirement planning and saving increasingly challenging. The asymmetry of information and lack of standards regulating financial advisors have made many investors vulnerable and reluctant to invest. This is not only a lost opportunity for investors, but the financial industry as a whole.

CARP calls for a legislated fiduciary duty as part of our advocacy for greater investor protection, including a full continuum of specialized information, investigation, prosecution and restitution. A legislated fiduciary duty has the potential to change the behaviour of financial advisors and lead advisors recognize their position of influence and act in their clients' best interest. A legislated fiduciary duty can be one of the most effective means of increasing the standard for all financial advisors, reducing investor vulnerability, and encouraging more savings and investments, all for the benefit of both investors and the financial industry.

## Who We Are

CARP is a national non-profit non-partisan association with 300,000 members across Canada. Most are retired, with above average education, income and net worth, but concerned about out-living their money, and about their children and grandchildren, who they see as not saving enough for retirement. We are in constant communication with our members through the pages of ZOOMER magazine, which reaches every household 9 times a year, and through our twice monthly e-newsletter, which reaches 90,000 email addresses and allows us to poll our membership on advocacy issues. Our members are highly engaged and vocal, and willing to act upon their convictions. On average, we receive 2,000-3,000 responses to the CARP polls in our newsletters.

## References

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<sup>ii</sup> Statistics Canada. RRSP Contributions 2011. <http://www.statcan.gc.ca/daily-quotidien/130211/dq130211aeng.htm>

<sup>iii</sup> Canadian Institute of Actuaries, Retirement Risk: Defining Retirement Horizons

<sup>iv</sup> CARP Investor Protection Poll Report. May 2012: <http://www.carp.ca/wp-content/uploads/2012/11/Financial-Report.pdf>

<sup>v</sup> Ibid.

<sup>vi</sup> Ibid

<sup>vii</sup> Ibid

<sup>viii</sup> Carpentier, Cecil and Suret, Jean-Marc, *Financial Knowledge and Rationality of Canadian Investors*, 2012: [https://www.lautorite.qc.ca/files/pdf/fonds-education-saine-gouvernance/finances-perso/fin-perso\\_ulaval\\_knowledge-rationality.pdf](https://www.lautorite.qc.ca/files/pdf/fonds-education-saine-gouvernance/finances-perso/fin-perso_ulaval_knowledge-rationality.pdf)

<sup>ix</sup> Ibid.

<sup>x</sup> Ibid.

<sup>xi</sup> Investor Education Fund. <http://www.getsmarteraboutmoney.ca/en/research/Our-research/Pages/financial-literacy-research.aspx#.UQgcDmeafcs>

<sup>xii</sup> Canadian Securities Administrators. <http://www.securities-administrators.ca/aboutcsa.aspx?id=1104>

<sup>xiii</sup> CARP Investor Protection Poll Report. May 2012. <http://www.carp.ca/2012/05/24/carp-investor-protection-poll-report/>

<sup>xiv</sup> Canadian Securities Administrators. 2012 CSA Investor Index. <http://www.securities-administrators.ca/investortools.aspx?id=1011>

<sup>xv</sup> Investor Education Fund. 2012. Investor behaviour and beliefs: Advisor relationships and investor decision-making study.

<sup>xvi</sup> Canadian Foundation for Advancement of Investor Rights. [http://faircanada.ca/wp-content/uploads/2012/06/Why-A-Fiduciary-Standard\\_-Kivenko.pdf](http://faircanada.ca/wp-content/uploads/2012/06/Why-A-Fiduciary-Standard_-Kivenko.pdf)

<sup>xvii</sup> CARP Investor Protection Poll Report. May 2012. <http://www.carp.ca/2012/05/24/carp-investor-protection-poll-report/>

<sup>xviii</sup> Ontario Securities Commission. <http://www.osc.gov.on.ca/en/22411.htm>