Screwed!

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Too many investors are being poorly served by the advisors managing their life savings. Here's how to avoid becoming the next victim

By Dan Bortolotti

"Our retirement dreams are in tatters."

The line jumps out from an email to *MoneySense* from a reader we'll call Ellen Thornton. The Thorntons' retirement portfolio once stood at $2.2 million, but as of early 2014 it had plummeted about 90% to just $225,000. Their advisor—who works with the wealth management arm of one of the Big Five banks—told the couple that $2 million wasn't enough to retire on and encouraged them to pile on risk in pursuit of higher returns. When Ellen's husband, Barry, complained, Ellen says he was belittled by the advisor. Barry was so shaken by the experience that during his tirade he suffered a pulmonary attack. The Thorntons filed a complaint with the bank's ombudsman, but they don't expect to recover their losses. "They prefer to spend a fortune on lawyers rather than putting things right for clients," Ellen wrote. "Yes, I am scared, but I have to fight this. Crying as I type."

The Thorntons' story is not as rare as it might sound: Far too many investors have, in some form or another, been screwed by their advisors.

Before going further, I need to disclose my own biases. I have been a journalist for more than 25 years and a *MoneySense* contributor since 2002, and I consider myself a staunch advocate for small investors. For the last two years, however, I have also been a full-time investment advisor with PWL Capital in Toronto, where my colleagues and I manage portfolios for about 150 client families. We use a fee-only business model and collect no commissions from the investments our clients hold (these are almost exclusively exchange-traded funds, GICs and low-cost mutual funds). Having spent time on both sides of the fence, I believe strongly that most Canadians need professional help with their money. But I have also seen first-hand how the financial industry is frequently guilty of doling out bad advice, delivering indifferent service, peddling awful products and charging too much for the privilege.

There's more depressing news: While there is a process for filing a complaint and seeking restitution (see "How to make a complaint" on page 32), it's difficult to navigate, frustratingly drawn out, and unlikely to help you recoup your losses. Here's how you can make sure you never get to that stage.

Licensed to sell

Some of the saddest cases of financial abuse involve criminals posing as legitimate advisors. These include high-profile cases like Earl Jones, who operated a Ponzi scheme in the Montreal area between 1982 and 2009, bilking his victims out of more than $50 million. Jones was not registered with any securities regulator: He was a fraud and eventually went to prison. Fortunately, the odds of learning your advisor is an unlicensed imposter are extremely low if you're a client of any well-established investment dealer. But before working with anyone whose background is unfamiliar to you, it's worth spending a few moments to check their registration.

Be warned, though, the regulations are confusing. Most investment advisors are licensed by one of two organizations: the Mutual Funds Dealers Association (MFDA) or the Investment Industry Regulatory Organization of Canada (IIROC). In general, advisors licensed through the MFDA deal only in mutual funds, while IIROC advisors can also recommend individual stocks and exchange-traded funds (ETFs).

It gets even more convoluted. There's a third category of advisors called "portfolio managers," who have special privileges and responsibilities which we'll touch upon later. Moreover, some advisors who are licensed only to sell insurance can also sell certain investments (though not traditional mutual funds, stocks or ETFs). Finally, independent financial planners—who often charge a flat fee or an hourly rate—are typically not licensed to recommend or sell any investments at all and do not fall under the jurisdiction of any regulator (except in Quebec). Yet these planners are frequently lumped in with investment advisors in the media and the public eye.

These may sound like minor technicalities but it's important to understand the distinctions, because the type of advisor you work with will have a big effect on your experience. And if that experience turns negative, it will help you understand where to file your complaint. So before becoming a client of any financial advisor, take the time to find out which type of license they hold and which investments they're allowed to sell.

The good news is the Canadian Securities Administrators (an umbrella organization for the 10 provincial securities regulators) makes this easy by allowing you to search for any investment advisor at aretheyregistered.ca. Anyone licensed by the MFDA or IIROC, or who holds the portfolio manager designation, should appear in this database. (Insurance and financial planners will not, however, unless they are also licensed investment advisors.) The CSA website (securities-administrators.ca) also allows you to see if your licensed advisor has ever been disciplined for misconduct.

Risky business

Even if a financial advisor is properly licensed, that's no guarantee he or she won't bend the rules. Perhaps the most common bone of contention between advisors and their clients is the suitability of investments in their portfolio.

Most advisors in Canada are held to what is called the "suitability standard." This means they must be able to demonstrate that an investment is appropriate based on the client's goals, experience, income and risk tolerance.

Sometimes it's easy to identify what's unsuitable. If you're 82 years old and explain clearly that you want only very conservative investments, your advisor would have a difficult time justifying the purchase of volatile junior oil stocks. However, if you're deemed to have a moderate- to high-risk tolerance, an advisor can fill your portfolio with high-cost, poorly performing funds—or even speculative penny stocks—and still argue these were suitable. "The suitability standard is weak: it has a lot of wiggle room," says Neil Gross, executive director of FAIR Canada, a non-profit that lobbies regulators on behalf of investors. "If you can tick the boxes in terms of investment objectives and risk tolerance, you can ram through a lot of investments that would not meet a best-interest standard."

Lazy advisors ignore even this weak standard and might begin recommending investments as soon as you meet for the first time, before they truly understand your goals and risk profile.

Before becoming a client of any advisor, take the time to find out which type of license they hold and which investments they're licensed to sell

To protect yourself, make sure you never sign a blank form when opening new accounts with an advisor

Last September, the Ontario Securities Commission, IIROC and the MFDA released the results of a joint "mystery shopping" survey they undertook in late 2014. The three regulators sent researchers posing as prospective clients to more than 100 dealers. They found that 29% of the advisors failed to comply with the know-your-client or suitability requirements and made investment recommendations during the initial meeting. Even worse, some advisors don't bother to explain the potential for losses in your portfolio. Advisors—and investors, for that matter—love to talk about potential returns, but you also need a realistic estimate of how much you could lose in the short term. I frequently speak to clients who expect a long-term return of, say, 7% but are unwilling to accept an annual loss of more than 10%. That's simply not realistic, and it's your advisor's job to explain that. You can broach the subject by asking how much the proposed portfolio declined during the financial crisis of 2008–09, when a traditional balanced portfolio of 60% stocks and 40% bonds could easily have fallen 20% or more.

The fine print

One of the most troubling trends in the industry is where advisors misrepresent their clients' risk profile when they fill out the paperwork. Some cases involve out-and-out forgery, where advisors fake the signatures of clients on important documents. But far more common is the practice of using "pre-signed blank forms," says Ken Kivenko, an investor advocate whose website is canadianfundwatch.com.

Here's how it usually works: You're presented with a stack of paperwork that needs to be completed before new accounts are opened. The advisor then rushes you through the process, encouraging you to sign documents without examining them closely. Then, after everything is signed, the advisor goes back and fills in the sections about risk tolerance. Kivenko says he has worked with seniors who complained to their investment dealer about losses in their portfolio, only to be presented with a signed document describing them as having a high risk tolerance. They recognize the signature as their own, but insist they would have never described themselves in that way.

That's exactly what happened to Cheryl Millard (not her real name). The Calgary woman and her 80-year-old mother met with two advisors from the investment arm of her bank. "At the meeting I explained that we had only ever invested in GICs," she says. The advisor then obtained her signature on the new account application forms *before* asking her about their risk profile, instead of after a thorough discussion. "I specifically told him that I have a low tolerance, and this is not what he put on the forms. He put down what he wanted, not what I told him." Millard said she requested only investments that wouldn't put her original principal at risk, but the advisor invested her money in traditional mutual funds, which have no such guarantees. Once she saw the value of her funds fluctuating daily, she quickly sold them, and fortunately avoided significant losses.

To protect yourself, make sure you never sign a blank form when opening new accounts with an advisor. If it would be too time-consuming to sign all of the paperwork in one meeting, take it home and review it on your own before you put your name at the bottom. You should also ask your advisor to make copies of these important documents for your own files: He's not required to provide you with copies unless you ask.

Borrowing time

Imagine you're at an annual investment review and your advisor suggests you're not quite on track to meet your retirement goals. Then she offers a suggestion: You can take out a line of credit, perhaps secured by your home equity, and use that borrowed money to top up your investments. With interest rates so low, it can seem like a no-brainer: borrow at 3% and invest in a portfolio that returned 8% or 9% over the last five years.

"We see this a lot," says Kivenko. Usually the advisor has a spreadsheet or chart showing how much better your investments would have performed if you had increased them using borrowed money, a practice called leverage. "They often don't show the downside, even though according to the regulations they are supposed to. They don't get into the risk discussion, or if they do, it's so superficial."

Let's consider that risk for a moment. If you borrow $100,000 at 3% and invest that cash in mutual funds charging 2%, you need to earn a return of 5% before you break even. You can't earn a return of 5% without taking considerable risk—and that risk is magnified when you use leverage. If your investments lose 20%, you'll find yourself on the hook for paying back $100,000 while the other side of your balance sheet has an $80,000 asset that has to overcome the double hurdles of interest payments and high fees.

Neil Gross of FAIR Canada is concerned that with interest rates so low, it's easier than ever to make a compelling pitch for borrowing and investors may not realize the inherent conflict of interest associated with this practice. "Advisors are incentivized to recommend leverage because their compensation is multiplied." The larger your account, the more your advisor earns, which means it's in his best interest to encourage leverage. The conflict of interest is even more glaring if the investment dealership itself is extending the loan or collecting management fees on the investments—or both.

The advice here is pretty clear: Don't borrow to invest, and be suspicious of an advisor who gets pushy. If you are a little behind in your retirement plan—and many of us are—the reality is you may need to spend a little less, save a little more or work a little longer. Ratcheting up your risk level with leverage is a dangerous way to make up for lost time. FAIR Canada agrees, arguing on its website, "that there is simply no reasonable basis for an advisor to conclude that a highly leveraged sale of investment products is suitable for any but the most sophisticated investor with a high tolerance for risk."

Buyer beware

Sometimes the conflict between investors and their advisors is focused on products that seem designed to confuse, frustrate and penalize. Perhaps no investment product is more maligned than mutual funds with deferred sales charges (DSCs), also known as back-end loads.

When you buy a mutual fund with a DSC, your advisor receives an up front commission (typically 5%) from the mutual fund company, but this amount is not deducted from your account as long as you agree to hold onto the fund for a specified period, usually six or seven years. On the surface of it, the concept of DSC funds may sound reasonable—they compensate the advisor for the initial planning work, the argument goes, and they encourage investors to buy-and-hold. But in reality they're frequently used to hold unhappy clients hostage.

Advisors who sell these funds are quick to point out that you can normally redeem 10% of the fund's value per year without triggering the sales charge, and that you can switch from one DSC fund to another in the same family (for example, from a Canadian equity fund to a bond fund) at no cost. They're less quick to acknowledge that an advisor has little incentive to deliver excellent service when he is paid an up front commission and the client's hands are tied for the next six years. One *MoneySense* reader was upset that her advisor routinely ignored her concerns, but although she was ready to fire him, she couldn't. "My advisor cleverly arranged it so all my money is locked in until 2020 unless I pay thousands of dollars in DSCs." I have also seen investors who still hold funds with DSCs despite being with an advisor for a decade or more. Once the initial investments mature, the advisor simply switched the client into a new crop of DSC funds and locked them in for another six years, scooping a tidy commission in the process.

These funds are also sold to shorter-term investors who are unlikely to remain invested for the full six or seven years, although this breaks the MFDA's own guidelines. In some cases, advisors have purchased DSC funds for seniors with Registered Retirement Income Funds (RRIFs), which have mandatory withdrawals each year. These seniors are then forced to sell a portion of their funds to make the annual withdrawal, thereby triggering the sales charge, which can be as high as 6%. "If you're 80 years old and you have a seven-year DSC you basically have to beat the statistics on longevity if you don't want to pay the DSC," says Kivenko. "And there's no escaping DSCs. Even if you die, you have to pay them."

Advisors must explain these consequences to their clients, but it's clear that countless investors have purchased DSC funds without truly understanding how they work. "If the regulators don't ban anything else, they should at least ban DSCs," says Kivenko. "They cause a lot of misery for people."

In your best interest?

So what can be done to hold advisors more accountable? One ray of hope is the Client Relationship Model Part 2 (CRM2), a series of regulatory changes that will be fully implemented by the end of 2016. For example, these will require advisors to fully disclose their fees in dollars as well as percentages, and require investment dealers to provide you with an annual report that includes your personal rate of return.

But it's not enough. "CRM2 is not a panacea," says Gross.

For their part, Gross and Kivenko have been promoting a fiduciary or "best-interest" standard for advisors, which would require them to put your interests before their own. That's very different from the weak "suitability standard" most are held to today. But they face strong headwinds from an investment industry keen to maintain the status quo. Industry lobbyists have argued that imposing such a standard could leave advisors vulnerable to being sued for losses that were triggered primarily by market events rather than negligence. Some have even argued that fear of litigation would drive good people out of the business, leaving Canadians with a dearth of good advice. "The fact is, many of the arguments that are put up against a fiduciary standard, or a best interest standard, are dubious," says Gross. "Why would you want to be out there arguing that it is *not* a good idea to act in your client's best interest? The arguments are almost laughable."

There are many fair and honest advisors in Canada, but this business will always attract more than its share of bad apples. Relying on the regulators to protect you from bad behaviour is naive. The best strategy is to be a savvy consumer who understands how the investment industry can bite you—and how you can avoid its teeth. M

HOW TO MAKE A COMPLAINT

You're convinced your advisor has breached the rules and made you lose money. Now what?

Unfortunately, while it's easy to make a complaint, the chances of recovering all of your losses are relatively low unless the breach is flagrant and easily proven. "The dispute resolution system is unsatisfying for everyone," says FAIR Canada's Neil Gross, a former securities lawyer who has defended both individuals and investment dealers.

You should also understand that the process is slow and the odds are against you. The role of the Mutual Fund Dealers Association (MFDA) and the Investment Industry Regulatory Organization of Canada (IIROC) is to ensure that dealer firms and their employees follow the rules, and they can discipline rogue advisors. But they are not going to act as your champion: They exist primarily to support the industry, not consumers.

1 Make a written complaint to your advisor's dealer firm. Provide a clear summary of your concerns and be as specific as possible. If you have supporting documentation, such as emails or notes from a meeting, include these with your complaint. You should expect a written response within 90 days.

2 You may also want to complain to your advisor's regulator. To do this you'll need to learn whether the dealer is under the jurisdiction of the MFDA or IIROC. Both regulators' websites have instructions on how to file complaints.

3 If you're not satisfied with the response you get from the dealer, you can make a complaint to the Ombudsman for Banking Services and Investments (OBSI). Be aware that OBSI is industry-funded, meaning it's not a government agency or regulator. In 2014, it ordered financial compensation in just 41% of the 539 complaints, it resolved and the median amount paid to the complainants was just $8,300. So don't get your hopes up.

4 If you're trying to recoup investment losses from an IIROC dealer, you can also consider arbitration. The dispute-resolution firm ADR Chambers (adrchambers.com) will hear from both sides and then make a binding decision. You may be responsible for paying half the cost of this process.

5 If the amount of money you're trying to recover is very large, consider taking legal action. But again, you should appreciate that going to court is expensive and time-consuming, and you can be sure the investment dealer will defend itself to the teeth. If they offer an out-of-court settlement, it might include a gag order to keep you quiet.

These steps apply in all provinces except Quebec, where the Autorité des marchés financiers (AMF) handles investor complaints. In Manitoba, New Brunswick and Saskatchewan, the provincial securities regulators can also order an investment dealer to pay compensation to a client. For more information on the dispute resolution process, visit the website for the Small Investor Protection Association (sipa.ca).