

## INVESTIGATION REPORT

**Date:** March 21, 2013  
**Client:** Ms. H  
**Firm:** Connor Financial Corporation (CFC)

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### INVESTIGATION SUMMARY

<b>Investment Advisor:</b>	▪ Mr. C	
<b>Issue:</b>	▪ Suitability of investments	
<b>Period:</b>	▪ December 1997 to September 2010	
<b>Key Conclusions:</b>	<ul style="list-style-type: none"> <li>▪ Based on her financial circumstances Ms. H, could not afford to take a high level of risk and should have invested primarily in lower-risk fixed-income investments.</li> <li>▪ Mr. C recommended unsuitable medium-high and high-risk investments and there was never enough lower-risk fixed income investments in her account.</li> <li>▪ Mr. C understated the risks of the investments he recommended to Ms. H. She had little investment knowledge and did not know she was unsuitably invested.</li> <li>▪ CFC is responsible for compensating Ms. H for the losses she incurred.</li> </ul>	
<b>Recommendation:</b>	\$91,307	Compensable losses from unsuitable investments
	\$2,129	Interest on recommendation
	\$93,436	Total recommendation

## **OVERVIEW**

Ms. H began investing with Connor Financial Corporation (CFC) in December 1997 after receiving half of the commuted value of her ex-husband's pension. She deposited the \$152,874 into a LIF account and started drawing an income immediately. Her only other source of income was Canada Pension Plan (CPP) disability payments.

Ms. H was 50 years old when she started investing with Mr. C. Her financial circumstances meant she required reliable income from and could not take significant risk with her investments. The portfolio that Mr. C recommended to Ms. H did not contain a suitable percentage of lower-risk fixed income investments, contained too many equity investments and exposed her to a significant amount of risk which was not at all suitable for her.

Mr. C did not recognize and consequently did not adequately disclose the risks of the higher-risk investments he recommended to Ms. H. We found that Ms. H had limited investment knowledge and experience and would not have known that the investment funds Mr. C recommended were higher-risk and therefore unsuitable.

We calculated that Ms. H incurred compensable losses of \$91,307 as a result of Mr. C's unsuitable recommendations. We are recommending that CFC compensate Ms. H this amount plus interest.

## **BACKGROUND**

- Mr. C was the founder, President, and sole director, compliance officer, and investment advisor of CFC.
- Ms. H and her husband divorced in 1995. In 1997, Ms. H received half of the commuted value of her ex-husband's company pension in the amount of \$152,874. In December 1997, Ms. H opened a LIF account with CFC and invested the proceeds. Ms. H was 50 years old at the time. She had virtually no assets other than her investments at CFC and her only source of income was Canada Pension Plan (CPP) disability payments.
- In 1998, Ms. H began withdrawing from her LIF the maximum annual amount allowable under provincial legislation to supplement her CPP disability payments. The maximum allowable annual amount, which increases with the recipient's age, is calculated at the beginning of each year and is based on a percentage of the market value of the account. In 1998, Ms. H withdrew \$9,475 from her LIF. However, the amount Ms. H was able to withdraw from her LIF each year decreased as the value of her account declined. In 2008, Ms. H received only \$4,760 in LIF payments.
- Between April 1998 and January 2005, Mr. C invested most of Ms. H's money in medium, medium-high, and high-risk bond, balanced and equity mutual funds. In February 2005, Mr. C recommended that Ms. H invest \$25,000 in the Mackenzie

Alternative Strategies Fund (Alternative Strategies Fund), a hedge fund, and switched all of her remaining funds to the Mackenzie Focus Far East Class (Far East Fund) and the Mackenzie Cundill Recovery Fund (Recovery Fund).

- Between March 2005 and March 2008, Mr. C recommended several switches between medium, medium-high, and high-risk equity mutual funds and other alternative investments. Ms. H said that she started having concerns about her investments in late 2008 and she tried contacting Mr. C several times but did not get a response. She said that in January 2009, she called Mackenzie Financial Corp. directly to find out about her investments.
- On February 2, 2009, Ms. H transferred her mutual funds, worth \$19,325 by this time, away from CFC. She sold them shortly after transferring and invested the full amount in a low-risk money market fund. The only investment fund that remained in her account at CFC was the Alternative Strategies Fund. It was blocked from redemptions until September 2010 because a significant portion of the fund was invested with Bernie Madoff's investment firm which was in receivership.

## **COMPLAINT**

On January 26, 2009, Ms. H emailed the MFDA to complain. On July 2, 2009, Ms. H emailed CFC with her complaint. In her letters to the MFDA and CFC, Ms. H said that:

- in 1997, she invested \$152,000 from a federal pension fund with CFC and Mr. C told her that she would only have access to a percentage of her principal because it had to remain "locked in";
- Mr. C assured her that she would get a good monthly income and that her portfolio value would increase, but shortly after opening her LIF account, her portfolio started to lose more money than she was receiving in monthly payments;
- the monthly payments she received started at over \$800 a month but declined to \$443 by the time she transferred her account away from CFC;
- the money she invested was her only source of income and she could not afford to lose it; and
- she told Mr. C many times that she had no knowledge of anything to do with investing and relied entirely on him to do everything for her.

Ms. H did not specify what compensation she was seeking, but asked for restitution in relation to her investments.

## **CFC'S RESPONSE**

In his letter to Ms. H of July 7, 2010, Mr. C said that:

- when she opened her LIF account in 1997, Ms. H advised CFC that she wanted the maximum income permitted from her LIF account beginning immediately;
- in 2002, Ms. H withdrew the maximum of 7% per year despite being told that no fixed income investment was available that could provide such a withdrawal rate without encroachment on capital. Therefore, CFC gave suggestions to invest for growth and Ms. H instructed CFC to proceed;
- in 2005, Ms. H wanted investments with more a stable history but with a potential for significant returns so CFC introduced the Alternative Strategies Fund, CWB Income Notes and Abria Guaranteed Alternative Investments (Abria Alternative Investments), which are designed to provide superior risk-adjusted returns through the use of alternative investments;
- the Recovery Fund was added in 2005 as a key equity position and despite a decline in unit price, the fund value has rebounded over 90% from its low in March 2009;
- the Cundill Emerging Markets Value Fund (Emerging Markets Fund) was part of the equity portion added in 2007 and though the economic downturn, coupled with a banking crisis, created unprecedented declines, the fund value has rebounded significantly (60%+) from its March 2009 lows; and
- based on the KYC information at the time, CFC considered all of these suggested choices suitable and consistent with Ms. H's investment objectives.

CFC did not offer compensation.

## **OBSI ANALYSIS**

In the course of our investigation, we reviewed correspondence between Ms. H and CFC, various account applications and account statements. In addition to interviewing Ms. H regarding the complaint, we interviewed Mr. C. We have also considered the applicable industry rules, regulations and practices.

OBSI examined the following key issues in respect of Ms. H's complaint:

1. What were Ms. H's personal and financial circumstances, investment experience and knowledge, risk tolerance and investment objectives?
2. Were the investments Mr. C recommended suitable?

3. If Ms. H’s investments were not suitable, did she suffer financial harm as a result?
4. Should Ms. H share responsibility for her losses?

**Issue 1 – What were Ms. H’s personal and financial circumstances investment experience and knowledge, risk tolerance and investment objectives?**

- Investment advisors are required to use diligence to ensure that the investments they recommend to their clients are suitable for them given their Know Your Client (KYC) information which includes their personal and financial circumstances, investment knowledge and experience, risk tolerance, and investment objectives. In order to meet this obligation, investment advisors must obtain and complete, timely and accurate KYC information.
- CFC was not able to provide documented Know Your Client (KYC) information for Ms. H between 1997, when she opened her account, and early 2005. The first Client Data Form CFC could provide was dated February 4, 2005. It contained the following information for her LIF account:

*Table 1: February 2005 Client Data Form*

Date of Birth	[redacted]
Time Horizon	20 Years +
Investment Objectives	Debt: 25 – 50% Growth: 50 - 75%
Investment Experience	Mutual Funds
Investment Knowledge	Good
Volatility	13 to 18
StdDev	Average
Annual Income	\$16,380
Net Worth	\$117,000
Fixed Assets	\$0
Liquid Assets	\$7,000
CFC Assets	\$109,790

- On May 31, 2007, Ms. H’s KYC information was updated to Volatility “19 +”, StdDev “Above Average”, Annual Income \$21,000 and Net Worth \$102,000. The rest of the information on her Client Data Form remained the same.
- Each of the Client Data Forms was a one-page document that Ms. H signed at the bottom. The KYC information was pre-printed on each form. There was no explanation of the various terms on the forms such as “Volatility” and “Std Dev”.

### **Personal and Financial Circumstances**

- Ms. H says she left her job as an Audio Visual Assistant in the Kingston, Ontario school system to move to Victoria, B.C. in 1990 or 1991. She received a small pension payout which she and her husband used to buy a condo. In Victoria, she worked odd jobs delivering newspapers, answering phones and picking flowers at a nursery until she and her husband divorced in 1995. Ms. H says that after they divorced, they could not find a buyer for their condo and she could not afford the payments, so it was repossessed by the bank. She says she got a job doing data-entry with the B.C. Government in 1996 or 1997 but could not continue because of her severe arthritis. In 1997 she applied for a CPP disability pension.
- Ms. H was 50 years old when she opened her LIF account with CFC in 1997 and deposited the \$152,874 she received from her ex-husband's pension. Ms. H says her only source of income at the time was her CPP disability payments which totaled approximately \$13,000 in 2009. She says that since her rent was almost \$10,000 per year, she relied on her LIF payments to supplement her CPP disability payments to help meet her expenses. The amount she received from her LIF account was about \$9,000 in 1998, 1999, 2000 and 2001, but fell to \$4,760 by 2008 as the value of her LIF account declined.
- Ms. H says her new partner moved into her rented apartment in 2000 and they shared expenses which eased her financial situation. However, he passed away in 2003, and she was again reliant on the income from her LIF account to pay her expenses.
- According to the Client Data Form, by 2005, Ms. H's investments at CFC were worth \$109,970 and she had about \$7,000 in other liquid assets. By 2007, Mr. C recorded Ms. H's net worth as even less, at \$102,000. Ms. H says she had no other assets or savings.
- Ms. H was not able to work and was on a disability pension. By 2005, she was 58 years old. She had no fixed assets and less than \$117,000 in investments to help supplement her government pension income over a potentially long retirement.

### **Investment Knowledge and Experience**

- Ms. H's investment knowledge was listed as "Good" on the 2005 and 2007 Client Data Forms.
- During our interview, Ms. H said that before receiving part of her ex-husband's pension, she never had any money to invest and she was not aware that her investment knowledge was listed as "Good" on the Client Data Form. Ms. H says that Mr. C explained investments using terms that she did not understand, but she completely trusted Mr. C and relied on him to give her a monthly income.

- Mr. C did not maintain client file notes and could not recall if Ms. H had any investment experience before investing with CFC.
- During our discussion with Ms. H, we found she understood she held mutual funds and that her income from them fluctuated in value depending on their performance. She knew that the mutual funds were not guaranteed, but did not understand the nature and risks of different types of mutual funds. While she understood, based on the graphs that Mr. C showed her, that her investments could fluctuate in value, she believed her investment values would always recover and she would not lose money. Ms. H did not have any understanding of general investment concepts like the relationship between risk and return. She also did not understand and could not accurately define terms that Mr. C used such as volatility and standard deviation.
- Based on our discussions with her, Ms. H had little investment knowledge and she relied completely on Mr. C's recommendations.

### **Investment Objectives and Risk Tolerance**

- Ms. H's Client Data Forms refer to investment objectives of 25 – 50% Debt and 50 - 75% Growth. We had never seen the term "Debt" used to describe investment objectives on a KYC document. The MFDA refers to categories of "growth", "income", and "balanced" and these are the categories most often used by firms.
- In our initial telephone interview, Mr. C said that "Debt" on the Client Data Form "refers to something with more lower (sic) volatility, almost like a yield".
- In the circumstance, given that the only other investment objective on the Client Data Forms is "Growth", we must conclude that "Debt" refers to debt instruments such as bonds or GICs, which is normally referred to on KYC forms as "Income" or "Fixed Income".
- CFC's Client Data Forms did not specifically refer to risk tolerance. Instead, they referred to "Std Dev" and "Volatility". On Ms. H's Client Data Forms, her "Std Dev" was recorded in 2005 as "Average" and in 2007 as "Above Average", and her "Volatility" was recorded in 2005 as "13 to 18" and in 2007 as "19+". We do not know of any investment firm that uses standard deviation to describe a client's risk tolerance. There was no explanation of these terms on the forms and the options for these categories were not listed. When we asked Mr. C what other options the client could have selected for "Std Dev" and "Volatility", he indicated they were:
  - 5 to 8: Much Below Average
  - 7 to 12: Below Average
  - 19+: Above Average
- In our interviews with him, Mr. C said that "StdDev" is an abbreviation of the term standard deviation and "average" is the average standard deviation of an equity portfolio and is similar to the risk of an average stock market. He said that he did not

use more common terms like low, medium or high to determine a client's risk tolerance, saying they "have no meaning because they are not relative to anything". Given Mr. C's explanations, and the categories available, we believe Ms. H's Client Data forms indicated a medium and medium-high risk tolerance.

- Mr. C says he had the same conversations with Ms. H as he did with all his other clients: he discussed "how much they want to have invested for growth versus lower volatility", which he assessed using the standard deviation of returns. While standard deviation is a common industry measure of investment risk, it is a technical term that would have no meaning for most investors, and certainly had no meaning for Ms. H. Mr. C has no notes of his discussions with Ms. H.
- In addition to using terms that Ms. H did not understand, the fact that no other options were listed on the form meant that Ms. H would not have known what risk she was accepting relative to her other options. As Mr. C suggests, not having a relative measure on the forms renders the terminology meaningless.
- Ms. H says she needed income from her investments and she was not willing or able to lose any of her money because she had no other assets or savings to fall back on.
- Mr. C said that because Ms. H wanted the maximum cash flow from her LIF account, she needed to invest more aggressively to receive higher rates of returns. However, investing more aggressively increased the risk that her LIF account would decline in value thereby lowering her allowable LIF payments.
- While we cannot agree that Ms. H needed to invest aggressively, she was in her fifties and needed her money to last a potentially long time. Therefore, she needed to receive a sufficient return to ensure that her withdrawals would be sustainable over the long term and would keep pace with inflation.
- In 1998, Ms. H withdrew the maximum from her LIF account which was about 6.2% ( $\$9,455/\$152,874 \times 100$ ) of her account value. As of December 1997, when she opened the account, five-year Government of Canada Bonds paid 5.35%. In 1998, the average five-year government of Canada Bond rate was 5.13%. In addition, Ms. H would have started receiving Old Age Security Payments at age 65, which would have been equivalent to about half of the amount she originally started withdrawing from her LIF. Therefore, while some enhanced returns for inflation protection would have been prudent, Ms. H did not need to take on a significant amount of risk and could have met her long-term needs by investing primarily in lower-risk, fixed-income investments.

## **Conclusion**

Ms. H had little investment knowledge and relied on Mr. C for investment advice. She needed her modest investments to provide her with income. Given her personal and financial circumstances, we find it clear she could not take significant risks with her



investments and we cannot accept that the Client Data Form which showed her as having a medium or medium-high risk tolerance and a 50% to 75% growth objective was accurate.

Ms. H said she could not take any risks with her investments and while it may have been reasonable for her to purchase investments with little or no risk, it also would have been reasonable, and arguably prudent, for her to have taken at least some risk with her investments. A common guideline suggests an investor should not allocate a percentage to equities greater than 100 minus their age. However, given that Ms. H was fully retired at age 50 and relied on her investments for immediate income, the guideline does not apply to her circumstances. Based on her circumstances we believe that no more than 25% of her investments should have been invested for growth, with the remaining 75% in lower-risk fixed income investments. If Mr. C had advised her appropriately and explained, in terms she could understand, the risks and reasons why taking virtually no risk may have been a risk in itself, we believe Ms. H could have understood and agreed to take some risk with her investments.

## **Issue 2 – Were Ms. H’s investments suitable?**

- We conducted a detailed assessment of the investments in Ms. H’s accounts at annual intervals from December 1998 to December 2008, shortly before she began transferring her investments away from CFC.
- From the outset, Ms. H’s account held virtually no lower-risk fixed income investments. Instead, almost her entire account was invested in medium, medium-high, and high-risk bond, balanced, and equity funds.
- By April 2005, her bond and balanced funds had been sold and Ms. H’s account was invested in medium-high and high-risk equity-based investments including sector mutual funds and a hedge fund, and two principal protected notes (PPNs), the Abria Guaranteed Alternative Income Notes and CWB Managed Futures Notes.
- In his letter to Ms. H, Mr. C said that the CWB was a government guaranteed structured note and that he recommended the CWB and Abria Notes because they provided a “minimum guarantee on the investment amount”. While these PPNs could have been considered low-medium risk if held to maturity, in July and September 2007 approximately two years after their purchase, Mr. C recommended that Ms. H sell the PPNs at a loss, foregoing any guaranteed capital protection they offered and exposing her to the market risks of the underlying higher-risk investments. Therefore, we assessed them as high-risk in our analysis.
- Overall, Ms. H’s portfolio did not contain a suitable percentage of lower-risk fixed income investments, contained too many equity investments and exposed her to a significant amount of risk which was not at all suitable for her.
- Mr. C explained to us that he recommended all the investments in Ms. H’s accounts to lower volatility or for growth and that all the investments fell within her equity

standard deviation. In addition, he said that he put Ms. H “in equities and with alternative strategies to have a superior risk adjusted return. Something that would give good downside protection”. Mr. C also told us that the return of the Alternative Strategies Fund would vary similarly to the performance of a portfolio of developed nations’ government bonds and therefore, its risk was similar to the risk of bonds.

- The primary document to determine an investment fund’s investment objectives and risk tolerance is its simplified prospectus or offering memorandum. These are the documents we used to determine the risks of Ms. H’s investments. For example, the offering memorandum for the Alternative Strategies Fund describes it as “only suitable for sophisticated investors seeking capital appreciation over the long term with a high tolerance for risk”.
- Mr. C told us he does not use simplified prospectuses or offering memorandum, but instead relies solely on an investment fund’s standard deviation to determine its risk. Standard deviation measures the variability in the historic returns of an investment or portfolio relative to its average return as a mean to predict the potential risk of an investment but it has limitations and should be considered along with other factors. For example standard deviation is not a good measure of risk for hedge funds, such as the Alternative Strategies Fund, which are not regularly priced. Mr. C could not provide us with any evidence that he had determined the standard deviation of any of the investments he recommended to Ms. H. Also, standard deviation is not a useful measure of risk for investments with a track record of less than three years. Since some of the investment funds had only been created a year or two before Ms. H purchased them, Mr. C could not have determined the standard deviation for those funds.
- In the circumstances, we cannot conclude that Mr. C properly disclosed to Ms. H the significant risk associated with her investments. Ms. H had little investment knowledge and did not understand the terminology Mr. C used. We find it clear she did not understand that her investments were too risky and were not suited to meet her income objective.

## **Conclusion**

Ms. H’s portfolio did not contain a suitable percentage of lower-risk fixed income investments, contained too many equity investments and exposed her to a significant amount of risk which was not at all suitable for her.

Mr. C did not understand the risks associated with the investment funds he recommended to Ms. H and he could not have properly disclosed the risks to her. Since Ms. H had little investment knowledge and relied on Mr. C’s advice, she did not understand and could not have independently determined that her investments were unsuitable.

### **Issue 3 – If Ms. H’s investments were not suitable, did she incur financial harm as a result?**

- Ms. H’s unsuitable portfolio declined in value by \$31,001. To determine if she incurred financial harm, we compared the performance of her actual unsuitable portfolio to the performance of a suitable one.
- On the basis that it would have been suitable for Ms. H to have invested 75% of her portfolio in lower-risk income investments, such as bond funds, and 25% of her portfolio in medium-risk equity mutual funds, we calculate that she would have gains of \$60,306 if she had been suitably invested. We used the DEX Universe Bond Index to represent the performance of lower-risk income investments and the TSX Composite Total Return Index to represent the performance of medium-risk equity mutual funds. Our calculations ran from December 1997 when Ms. H opened her account, to September 2010 when Alternative Strategies could finally be sold, and accounted for the timing of her deposits and withdrawals. Since indices do not include management fees that would normally be charged on a mutual funds, we adjusted the performance of each index by the average fee that would have been charged for fixed-income and equity mutual funds respectively. Using this approach, we calculate Ms. H’s financial harm as \$91,307 (\$31,001 + \$60,306).

### **Issue 4 – Should Ms. H share responsibility for her losses?**

- In this case, Mr. C allowed Ms. H’s accounts to be unsuitably invested contrary even to the inaccurate KYC information Mr. C recorded for her accounts.
- In his letter to Ms. H of July 7, 2010, Mr. C said “CFC gave investment suggestions based upon your instructions in invest for growth and you instructed CFC to proceed with those investments.”
- An advisor’s primary responsibility is to make suitable recommendations. The fact that Ms. H may have followed Mr. C’s recommendations does not make otherwise unsuitable investments suitable. It remains that Mr. C recommended unsuitable investments. In *Re Daubney*, (2008) 31 OSCB 4817, the Ontario Securities Commission panel said the duty of care with respect to the recommendation of suitable investments is on “the registrant who is better placed to understand the risks and benefits of any particular investment product. That duty cannot be transferred to the client.” Mr. C could not have told Ms. H that many of the investment funds he was recommending were high-risk because he did not understand that himself. Instead, he indicated that her investments were suitable and that many of the high-risk investments he recommended were low-moderate risk funds based on their low volatility. Ms. H could not have known that Mr. C’s use of volatility as a measure of the risk of these funds was inaccurate and seriously understated their risks.
- Ms. H had little investment knowledge and she relied on Mr. C. She says she trusted him and had no reason to question his advice. She says when she saw her account

value declining, she raised her concern with Mr. C and he would tell her that the markets were just about to get better and to stay the course. She said she started to question her investments in late 2008 when their value declined significantly. She complained shortly after to the MFDA in January 2009 and began transferring her investments away in February 2009.

- The case law is clear that investment firms are vicariously liable for the actions of their investment advisors in regard to securities-related business. As Mr. Justice D.J. Gordon said in *Blackburn v. Midland Walwyn Capital Inc.* [2003] O.J. No. 621 (OSCJ), affirmed on appeal [2005] O.J. No. 678 (OCA), at para 191 regarding vicarious liability: "...a firm is absolutely responsible for the conduct of its stockbroker." The reasons for holding investment firms liable for the conduct of their investment advisors were explained by McLachlin J., as she then was, in *Bazley v. Curry*, [1999] 2 S.C.R. 534 (S.C.C.), at para 31:

Vicarious liability is arguably fair in this sense. The employer puts in the community an enterprise which carries with it certain risks. When those risks materialize and cause injury to a member of the public despite the employer's reasonable efforts, it is fair that the persons or organization that created the enterprise and hence the risk should bear the loss. This accords with the notion that it is right and just that the person who creates a risk bear the loss when the risk ripens into harm.

- In this case, CFC is vicariously liable for the actions of Mr. C in failing to ensure the Ms. H's investments were suitable for her.
- It does not appear to us that there is any basis to impose responsibility on Ms. H, because she did not act negligently. It would be unfair to apportion responsibility to her for the financial harm arising from Mr. C's unsuitable recommendations.

## **Recommendation**

For the reasons outlined above, we recommend that CFC compensate Ms. H \$91,307 for her losses plus interest of \$2,129 for total compensation of \$93,436.<sup>1</sup>

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<sup>1</sup> Interest is calculated using the average 3-month Canadian Treasury Bill yield of 0.93% (as calculated by the Bank of Canada) compounded annually to the date OBSI's report is final.