Kenmar Associates
Investor protection and education

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OBSI Consultation paper -Suitability and Loss Assessment process

Kenmar Associates have been actively tracking OBSI ever since it became the Ombuds service for investments in 2002. We have issued Reports on its decisions, its Annual Report(s) , its operations, its Terms of Reference and its governance . We have acted as Intervenors or supported complainants in other ways. We have issued a Guide for retail investors on how to deal with OBSI . Thus ,we feel well qualified to comment on this topic.

We welcome the opportunity to submit our comments for consideration. OBSI is generally recognized as the nation's banking and investment Ombudsman. The Ombudsman can serve as a bulwark of financial consumer democracy in troubled times, protecting citizens and helping industry, regulators and government to improve in the face of a tough economy and fiscal constraint. Any improvement to OBSI processes and methodology is in the public interest.

The OBSI Consultation has resulted because of complaints and threats from a few investment dealers. They assert OBSI is being unfair in their calculations . Of course the real problem is the abuse sales Reps [aka "advisers"] are inflicting on Main Street. The fact that OBSI needs to calculate losses is only the symptom of the problem. The KYC system is broken and suitability standards are weak and ill-defined. Investment Policy Statements and Engagement Letters would help but they are not required by regulators and hence , infrequently used. This lack of regulatory engagement makes the OBSI complaint handling process much more difficult than it should be.

We note also that, in the vast majority of cases, investors place a high level of trust in their "advisors". This is confirmed by a number of studies including those conducted by IFIC www.ific.ca

Overall, we find the OBSI approach to be logical , disciplined and fair to investors and dealers. It appears to follow International Standard ISO 10003 quite closely. From our experience , it is well ahead of the complaint handling processes and disclosure practices used by most investment and mutual fund dealers.

"I think we've got a lot of work to do on the culture of complaint handling and dispute resolution in financial services,There are some firms that have worked hard at it, but we also see some behaviour that really suggests to me they don't get it. It's the tactics of delay, it's the automatic no, it's the attitude of, 'Get this into the hands of legal and start the formal letters.'" - former Ombudsman for Banking Services and Investments, David Agnew on his departure in 2009 .

We start with the Title of the Paper. We believe it should read *Suitability and Client Restitution.* As pointed out in the Paper, compensation may be appropriate even when no direct loss has occurred but an expected earnings opportunity has been foregone.

The Investment Environment

A compensation calculation that *makes people whole* from an industry that holds itself out as a trusted source of advice must include opportunity costs . The abuses we see are truly disturbing . The investment industry too frequently uses false and misleading representations as to the roles, titles, and compensation of those they employ as "advisors".Further information regarding the misleading marketing practices that are considered standard operating procedure by the industry can be found at http://www.investorvoice.ca with particular attention to the MARKARIAN vs CIBC WORLD MARKETS discussion of false and misleading sales practices and title inflation by a Quebec Superior Court Judge. http://investorvoice.ca/Cases/Investor/ ... _index.htm Lofty slogans complete the inducement to trust the industry [Invest with Advice , Freedom 55, "You're Richer than you think", Buy, Hold...Prosper]. Too often,investors are lured into a relationship that is unfriendly , if not hostile, to them. They , especially seniors and retirees , are defenseless in this scenario. All this hype essentially puts the retail investors nesteggs in the hands of the dealers and their salespersons whom they trust, often unconditionally. So when unsuitable investments are recommended , natural justice dictates that the client should be made whole.

SUITABILITY COMPLAINTS

The NAAF form needs to be improved and standardized across the industry .The NAAF is the first document trying to capture and communicate important investor information. New Account Application Forms try to assess client risk tolerance and investment objectives through checking off a few blocks on the form. The form contains only barebones and generalities. Too often it like putting a square peg into a round hole. The client might have goals to save for a house or an

education, but the forms only allow investors to check off Objectives like "growth" or "income" or "safety of principal". They come without definitions or any description of the associated risks. Nevertheless, this form is often the primary basis used by advisors in justifying investment recommendations.

The Dec. 2003 *OSC Regulatory Burden Task Force Report* recommended that there should be a mandated KYC form with definitions that are more understandable. Additionally, they stated:

1. Registrants should be required to follow mandated procedures regarding their use of the form with investors.

2. The form should require signature by the investor in all cases (with a copy retained by the investor) and all changes in the investor information contained in the form should require initialing by the customer.

3. The form should also contain clear bold-faced instructions to the investor as to how to best use the form to protect themselves and how to pursue a complaint regarding their account, with the registrant and its internal ombudsman and, if necessary, with the OBSI [Ombudsman for Banking Services and Investments].

4. The Commission and the IDA [now IIROC] should consider requiring registrants to send clients copies of their KYC form annually together with a request to advise the registrant if the information in the form should be amended...

Source: http://www.osc.gov.on.ca/About/Governance/Accountability/ga_20031212_rbtf-rpt.pdf Investor advocates continue to press for these unaddressed improvements to be implemented. See also our commentary under KYC Determination

In the case of an demonstrably unsuitably completed form or one that has been adulterated, OBSI should consider this an automatic loss for the dealer and a report sent to the applicable regulator(s) .

CONTEXT UNDERLYING OBSI's APPROACH

Step 1 – KYC Determination

Documents, such as NAAF forms, are central to an investigation. We too have noted that in many complaints, the investor demonstrates that their KYC

information was not accurately recorded, that they did not understand the KYC forms /terminology they signed, and/or that their Rep did not review the KYC forms or explain their significance. Sometimes, a blank NAAF has been signed and filled in by the dealer Rep. The practice of collecting and considering additional evidence by interviewing the parties and conducting research to determine if the KYC forms reflect the investor's actual KYC information during the period of time in question is very good and necessary. We do have some reservations about the interview process and how it is conducted but we certainly agree that documents alone may not tell the whole story. The organized OBSI review approach makes a lot of sense.

Step 2 – Suitability Analysis

The analysis of the investments and strategies recommended by the advisor to determine if they were suitable for the investor based on their KYC information is fine IF the KYC info. is correct and up to date. We concur that if the investments were suitable and the Rep accurately described them to the investor, OBSI generally should not recommend that the firm compensate the investor. But please note that suitability determination must consider time horizon and age .It also must consider liquidity e.g. an 85 year old being sold a 7 year DSC mutual fund would in our view , be an unsuitable investment, even if the fund itself wasn't too risky.

The advisor's responsibility is to recommend investments that meet the investor's objectives. If the investments were unsuitable and the investor has been harmed we would expect compensation to be made. The suitability requirement is complementary to the fundamental obligation under securities legislation for dealers and their representatives to deal fairly, honestly and in good faith with retail investors. National Instrument NI 31-103 also states that the (advisor) "*registered representative is responsible for the advice given. In providing this advice, the registered representative must meet an **appropriate standard of care**, provide **suitable investment recommendations** and provide **unbiased investment advice***". The fundamental obligation includes a duty to disclose known or discoverable risks to the investor before entering into any transaction for a particular security.

Another important point involving suitability ties in with Bernoulli's Hypothesis. Mathematician David Bernoulli's Hypothesis states that an investor's acceptance of risk should incorporate not only the possible losses that can occur, but also the utility, or intrinsic value, of the investment itself. For example, a retired investor with ample savings already accumulated should not be exposed to a highly volatile or risky investment, as the potential benefits are unlikely to be worth the

risk even if he/she has the risk tolerance and loss capacity associated with the risk .

Please add that the method of financing the trade, whether or not the financing is provided by the Dealer ,is also a key suitability factor . This is especially important for the elderly and retirees, a growing demographic.

Loss Capacity, income tax issues and liquidity are especially important suitability issues for seniors. Loss Capacity is the ability to with-stand and recover from a bear market. It is primarily determined by age,health, income/expenses, time horizon and level of savings/net worth. It is not the same as Risk tolerance. Leveraging adds risk to a portfolio and undue risk , if it is unnecessary or excessive ,should also be a factor in OBSI's suitability determination(s).

We fully concur that the overall objective of OBSI's approach should be to determine a reasonable estimate of the financial position the investor would be in had the unsuitable investment advice not been given and acted upon. Investors pay for advice and when bad advice is given, they deserve compensation. We don't disagree that an OBSI recommendation should be well supported but so should the dealer's original rejection of a investor complaint. By concentrating on the facts, client documents/notes/emails, dealer files and the dealer's rationale for rejection ,OBSI should be able to make sound recommendations. If a firm is unwilling or unable to provide requested documents or tapes , OBSI should use good judgment in discerning the reality of a situation.

Step 3 – Determining Financial Harm and Compensation

It is understandable that OBSI would have several options for calculating whether an investor incurred financial harm as a result of unsuitable investments. It is very important to define financial harm. We believe that *making a person whole* is the most logical approach , whenever it is applicable.

We do not disagree that the investor should bear responsibility for some of the loss in certain cases. The considerations would include but not be limited to:

- Client history of trading/ pattern
- Was the trade *Investor initiated*?
- The investor's investing experience ,knowledge and analytic capability
- The complexity of the security or trading strategy
- The representations made by the dealer Rep
- Did the Rep apply any risk containment measures in the portfolio construction? e.g. use of derivatives

- Did the salesperson pro-actively recommend sale to minimize losses?
- The physical and mental health of the investor (eg. dementia)

If it is determined that the dealer Rep did not have the necessary professional credentials , training or experience , we would argue that the investor should be largely immunized from any responsibility.

OBSI should perhaps explain their harm assessment methodology in more detail but the general concept of compensating opportunity losses is fair and reasonable. If it were any other way , restitution would be limited to the loss incurred - for a senior or retiree especially, that could mean several critical years of potential earnings would be lost forever. It would mean that RRSP's/RRIF's could not be repaired. It would also mean that reckless or incompetent behaviour would not carry much financial risk for industry participants .We think of unsuitable investment recommendations as unauthorized trades and therefore the loss calculation should include opportunity costs. It is simply a matter of fairness. [OBSI is not a regulator -it cannot fine wrongdoers , order disgorgement or assign punitive damages. so opportunity costs [Options 4./5.] are the only available route for fair compensation for demonstrably defective advice]. THE UK Financial Ombudsman Service routinely uses notional portfolios [portfolios chosen to mimic the likely suitable portfolio] to assess restitution. The Service has a Guide to Redress calculations at http://www.financial-ombudsman.org.uk/publications/technical_notes/QG5.pdf

Of the 6 options for calculating loss (page 9) some are grossly unfair. For example 6. would expose the investor to information and knowledge asymmetry that would work against most investors. In any event, this should be done prior to OBSI involvement if the investor so wishes. Option 1. is inappropriate when a client is being charged for advice and has placed trust in the adviser. Option 2. might be acceptable in cases where an administrative/computer error was made and the period over which the loss took place is relatively short. This involves some considerable judgment. Ditto for option 3.Option 4. seems to us to be more difficult to apply in practice and is subject to more debate. For any calculation using a notional portfolios , consideration should be given to portfolio rebalancing over the timeframe under dispute. When using Indexes, the median fee of an Index fund should be used since the raw Indexes are frictionless, costless and uninvestable. This makes the loss calculation more fair to dealers and investors.

We add parenthetically that some considerable harm may be due to what we refer to as asset Location- the harm occurs due to putting the investments into the wrong type of account. Based on our experience we see this type of defective advice on the rise. In APPENDIX II we show how unsuitable asset Location can

cause harm.

Another concern is with so-called "Off-Book" Transactions. Theses can be particularly harmful. OBSI should accept such complaints despite the fact that some firms deny responsibility for such transactions. Dealers should be responsible for supervision of those whom they characterize as advisers. A related concern is that there is a movement for advisors to incorporate. Regulators must take extraordinary measures that the chain of liability is not broken by this maneuver and that OBSI remains as an option for complainants.

Mutual Funds

OBSI states that with very few exceptions, when assessing mutual funds, the investment objectives, investment strategies (including the asset allocation), and risk ratings published in the mutual fund company's Simplified Prospectus are used. We caution that very often the fund's objectives are so broad as to be meaningless. Much of the text is written in legalese. Also, the Simplified Prospectus will no longer be automatically distributed to investors after July , 2011. It is being replaced by Fund Facts, a document we have asserted provides misleading disclosure concerning risk (the Risk rating) as well as other serious shortcomings.

Disclosure Doesn't Validate an Unsuitable Recommendation

We agree that disclosing the risks and characteristics of a recommended investment or strategy is a key element of an investment advisor's and firm's responsibilities. However, disclosing information or providing investment literature does not negate the advisor's obligation to recommend suitable investments . We agree with OBSI that disclosure does not make an investment or strategy suitable if it's otherwise mismatched with the investor's objectives ,personal situation, risk tolerance and loss capacity.

Although disclosure is often advanced as a potential solution to conflicts -of-interest, academic research on disclosure has found both positive and negative effects. In a recent paper *The Burden of Disclosure* ,the authors present 3 experiments that reveal a previously unrecognized perverse effect of disclosure: Disclosure of an adviser's conflict-of-interest can decrease investors' trust in the advice while simultaneously increasing pressure to comply with that advice. This compliance pressure comes from two mechanisms: (1) recipients fear signaling distrust of the adviser, and (2) recipients feel an increased pressure to help their adviser when the adviser's personal interests have been disclosed. Hence, disclosure can place a burden on those it was supposed to protect. Additionally, advisers may feel morally licensed to offer biased advice once they've disclosed all the issues and conflicts-of-interest. Thus, disclosure can lead advisors to give even more biased advice to retail investors once they have disclosed their

conflicts- of- interest! Download paper at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1615025

Mitigating Losses

We have no disagreement with the boilerplate language in the Paper. It is indeed a principle of dispute resolvers and legal jurisprudence that clients have a duty to mitigate losses when they become aware of them. Easier said than done, especially for unsophisticated investors. Retail investors , are faced with DSC early redemption penalties, and what behavioural finance researchers refer to as Loss Aversion, the psychological force that makes it painful to take a loss. Too often an investment fund is sold on a DSC basis without any logic or supporting rationale. Further, since most Client Statements don''t provide enough information to really determine how a portfolio is performing versus plans, timely mitigation is very hard to do. It is rare indeed for a Client Statement to present personalized rate of return information for example. If a Rep formally recommended sale on unsuitability grounds, then that should be the point OBSi should take as the mitigation date.

Further, the advisor may actually recommend to buy- and- hold (while he/she of course collects trailer commissions) . In such a case an investor who trusts his/her adviser would likely not sell to mitigate further loss. This needs to be a consideration . Finally, investor advocates argue that an advisor has a duty to **pro-actively** recommend a change in Portfolio if it is not performing in accordance with expectations and /or the NAAF-KYC . After all, clients are paying for his/her expertise - timely advice on selling/ portfolio rebalancing, not just purchases, is an integral part of the advice. The management of risk is an integral part of providing advice and the absence of any adviser recommendation to sell should be taken into account by OBSI in allocating responsibility and defining a mitigation date. See Attachment I for additional thoughts on mitigation as it applies to retail investors .

What's compensatable , what's not

As a general observation , industry participants and OBSI should publicly clarify for investors which items of financial loss are subject to compensation and which are not- for example :

- Actual investment losses due to unsuitable investments or other

causes
- Excessive or unnecessary fees paid
- Early redemption penalties to exit unsuitable investments
- Interest charges for *unnecessary* margin or loans
- *Excessive* sales commissions
- Undue income tax liabilities/penalties as a result of churning or unsuitable investments
- The costs associated with preparing the claim/complaint
- Opportunity costs /losses
- Consequential damages
- Costs incurred such as interest on loans for living expenses directly necessitated by the unsuitable investments/transactions
- Interest expenses

Publication of decisions, case summaries and statistics

We believe that above all else the complaint handling system must be transparent. We expect that the following benefits will be derived by publication of complaint documentation:

- Education for complainants , investors and industry participants
- Spotlight industry opportunities for improvement
- A cross-check on decision consistency and fairness
- A source of information for regulators to revisit rules /compliance processes
- An identification of emerging / systemic issues impacting investors
- Acceptance of the OBSI process by financial consumers
- Assessment by analysts, academia, media and others
- Identification of Best Practices

The publication of information is not intended as a form of jurisprudence. It's hard to imagine a more cost-efficient way protect investors than by letting them know where the financial land mines are buried. Anonymity of course would have to be maintained . A few Case Studies are inadequate .

Perhaps even more importantly, the Joint Standing committee on Retail Investor Issues needs to be reactivated. After an initial bold declaration by the OSC, MFDA, IIROC and OBSI in the Spring of 2008, little has been heard from this Committee. The original idea to create a permanent forum in which the four organizations could discuss the problems that afflict retail investors — and to work together on possible solutions- is even more critical today than it was 3 years ago. We strongly recommend that the OBSI Board demonstrate leadership by empowering staff to move forward .OBSI's vast

database of complaints is a treasure trove of information necessary to establish regulatory policy.

We note that the OK ombudsman service has, as of November 2010, published content on its online technical resource covering more than 90% of its caseload. This helps firms, when considering complaints themselves, to judge what complaints the ombudsman is likely to uphold.

In our opinion , dealers should take account of OBSI decisions and guidance in assessing a complaint. We believe that the guidance will help firms operate management processes so that relevant learning from ombudsman recommendations and published material are identified and cascaded to complaint handlers.

Final Compensation Assessment

We agree that ,using the steps prescribed , a fair compensation can be assessed.

In some cases ,OBSI may recommend that the firm also pay the investor interest on the compensable losses they've calculated. We agree with the example, where if the investor complained in a timely manner, but it took an undue period (we'd suggest > 90 days) for the complaint to finally be resolved, that OBSI include interest on the compensable losses from the date of the complaint to the date it’s resolved (recommendations documented) based on the average 90-day Canadian Treasury Bill rate over the time frame. That being said,we urge the OBSI to set a higher performance standard than 80%/180 days for cycle time.

We also agree with OBSI's compensation policy for non-financial losses . Ref. https://www.obsi.ca//images/document/up-NFL_Approach_Sept_07_Fin.pdf
The amounts cited however are very small and deserve upgrading given that they may involve loss of reputation, damage to credit ratings and loss of privacy.

The $350,000 compensation limit hasn't changed since 2002. We recommend that it be increased to maintain the degree of consumer protection afforded by the ombudsman service in real dollar terms.

Conclusion

In conclusion, Kenmar Associates supports the OBSI approach .It is our conviction that the Consultation Paper exhibits a professional complaint handling approach and a determined effort to be fair to dealers and retail investors.

Kenmar Associates
Investor protection and education

We urge securities regulators to protect investors by resisting any attempt to dismantle or weaken OBSI. We urge the CSA, IIROC, and the MFDA not to buckle under to intense industry pressures to remove the definitive requirement for dealers to participate in the OBSI complaint assessment process. In fact , we urge regulatory reforms to strengthen the accountability and independence of OBSI and to ensure that it retains its status as the single source for dispute resolution for banking and investment complaints in Canada. In the end ,we expect that having OBSI implemented by Parliamentary dictate is the only way to free the entity of undue industry influence and investor perceptions of a pro-industry bias.

Further , the financial services industry should be asked to explain why the number of complaints is so high . They too should be asked to publicly reveal their loss calculation methods and justify them. They should be asked to justify why they do not compensate for " opportunity losses". They should be asked to correct glaring deficiencies in their investor protection protocols including , in particular , the Know-Your-Client regime. They should be asked to quantify how serious the problem of "advisers" secretly [under-] compensating investors is- we suspect it's greater than most people think.

We would welcome an opportunity to meet with you and discuss this critical issue.

Should you wish to disclose or post this letter on websites , permission is granted.

Sincerely,

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ATTACHMENT I: Mitigation Date

Setting the date at which mitigation of losses should take place is crucial -it is no trivial task. Our experience suggests several forces are at work :

1 Clients may not know the extent of their losses until late in the game:

- Client statements rarely provide personal rates of return.
- Book values obscure rather than illuminate security performance.
- Suitable investments may temporarily mask the corrosive effects of unsuitable investments.
- Some mutual fund and hedge fund managers report semi-annually or even annually.

2. For many reasons, a specific investment may be unsuitable for an investor. Advisers may not want to admit to responsibility for the error and therefore encourage ignoring the unsuitability, hoping the losing investment will recover. Lucrative trailer commissions may also incent advisers to not recommend selling a losing investment and so the retail investor holds on. DSC- sold mutual funds result in an early redemption penalty that further discourages selling a loser .These forces combine to encourage the investor to inappropriately hold on to losing investments he/she may not even know are in fact unsuitable investments. A year or more can easily be lost in this morass.

3.Behavioural finance scientists have studied retail investor behavior and concluded investors go through a multi-phase internal process before they decide to react to bad news . Embarrassment, the fear of regret, outright psychological depression, anchoring and cognitive dissonance are all factors that may cause investors to delay facing the reality that significant losses have been incurred and to take action. This cycle of denial should be considered when setting a mitigation date involving unsophisticated retail investors.

4. Once an investor suspects he can and should complain he must go through a long, extended and stressful process with the fund dealers and brokers. Before it's over an investor must deal with his advisor, a branch supervisor, a Vice President, a compliance officer and the firm's ombudsman. During this complex process, documents are exchanged, there are many phone calls and meetings are held. Sometimes key documents are missing or the advisor has left the company. The brokerage firm may cause delays, with long response times and obtuse replies begging for explanations that are not forthcoming. This phase alone can take many months. Not infrequently , the investor is told his/her claim is not valid [even in cases where OBSI or the Courts later uphold the claim as valid.]It is only after all this that an investor can be reasonably sure he has been sold an unsuitable investment and must take action.

5.The stress of a life-altering event such as the loss of a hard earned retirement nest egg can be so debilitating that it can lead to depression and the inability to make a rational decision. In this mode, it’s unlikely an investor will have the emotional strength to focus on mitigation.

6. Clients may not understand or be told that they must sell a losing investment in order to baseline their claim. Some actually believe that selling will disadvantage their claim.

7 When an outside party is consulted they will require a period of time to investigate the material facts and to determine whether the investor is on a solid footing in determining the investment(s) are unsuitable . The time required will depend on the complexity of the claim. Only after the consultant has validated unsuitability should mitigation be expected.

An interesting issue illustrated by a 2010 article by law firm Borden Ladner Gervais LLP (**BLG**) concerns litigation against financial advisors and whether the client has brought their action in time. The article points out that in broker/adviser cases it can be difficult to ascertain exactly when the adviser went offside and, more importantly, when the client discovered that they might have a cause of action. An April 20, 2010 decision of the Alberta Court of Appeal indicates that how the action is framed against the broker can be an important factor. In that case, the client's claim for negligence was summarily dismissed, but her claim for recklessness has been allowed to proceed. In a broker context, investment firms and investors alike should be aware that when it comes to the application of a limitation period, the two year "drop dead" date can apply or not apply depending on how the cause of action is framed and how effectively the investor can argue that he/she did not know **all** the facts pertinent to their claim until a certain point. Source: BLG, http://www.mondaq.com/canada/article.asp?articleid=113932&email_access=on

Another case is worthy of note . "An Ontario court is letting a case proceed to trial in which a mutual fund dealer is suing a former consultant over allegedly poor advice provided to two clients. The province's Superior Court of Justice has ruled that there is a genuine issue requiring a trial in a suit brought by Investors Group Financial Services Inc. [IGFSI] against a former consultant, Alex McKee. According to the decision, the action brought by Investors Group is seeking $150,000 in damages for breach of contract and, alternatively, breach of fiduciary duty. The firm alleges McKee provided negligent investment advice to a pair of clients when he recommended a leveraged investment strategy to them . McKee brought a motion seeking dismissal of the action on the basis that it was commenced outside the two-year limitation period. He argued that the firm became aware of the clients' complaint about the quality of the advice they had received in October 2004, meaning the statement of claim against him by the firm was out of time when it was served in November 2006.

The firm argued that the limitation period did not begin to run until after its investigation into their complaint was completed in December 2005 [14 mos. after initial complaint!] , as that was the point when it realized it might have a claim against McKee. After an investigation of the clients' complaint, the firm entered into a settlement with the clients in March 2006, in which it paid $150,000. It began an action in November 2006 seeking $150,000 in damages from McKee. In this case, the court found that there is a genuine issue requiring a trial. "I do not accept the defendant's submission that the plaintiff knew of the clients' complaint about negligent advice in October 2004, so that the limitation period began to run at that time," the court said. Instead, the court said that the essence of the complaint in October 2004 was the amount of the charges imposed on the clients, and that complaint was settled. A second complaint regarding the quality of the advice provided was lodged in March 2005. "There is no indication in that letter that the clients had taken issue with the quality of the advice earlier, or that they had sought compensation from the plaintiff for it," the Court notes.
"The defendant has not satisfied me that the limitation period began to run in October 2004, and, therefore, that the action is statute-barred. As there is a genuine issue requiring a trial, the motion for

summary judgment is dismissed," the concluded, awarding the firm costs of $7,500.00, payable within 30 days. " Source: http://www.investmentexecutive.com/client/en/News/DetailNews.asp

APPENDIX II : Asset Location can lead to Loss

Each individual has unique circumstances and constraints. That's why investors and their advisors need to carefully think through where assets should be located (account type) .

We recall one disturbing case where a mutual fund salesman levered up an investor to buy more mutual funds for her RRSP. The majority of the funds related to technology ,the internet and e –commerce. When these funds tanked in 2002, the investor decided to sell them at a huge loss. The first problem, besides the unsuitable recommendations, was that interest on RRSP loans was not tax- deductible despite the salesman's assurances that it was. Second, ,because she had located these highly volatile funds in a tax-deferred account, she could not deduct the capital losses from capital gains. Finally, because she was no longer contributing to her RRSP, the account's capital base had taken a virtually irrecoverable jolt.

One of the worst examples of asset mis-location involved a RESP account. Either hungry for lucrative commissions or just incompetent, a broker recommended a LSIF for a RESP that would soon need to be drawn down as the child was approaching university age. LSIFs provide venture capital to small and medium-sized business enterprises; the funds allow investors to pool their resources to invest in small businesses in need of funds for growth. Investments in LSIFs qualify for the federal LSIF tax credit, and where applicable, an additional provincial tax credit. For federal income tax purposes, an investor purchasing shares in a LSIF is entitled to a credit of 15% of up to $5,000 of the cost of the shares, for a maximum credit of $750 per year. In those provinces that also provide credits, it is possible to double up the total credit. As an inducement to investors to hold for the long run, the government requires that investors hold onto their investments for a minimum period of 8 years. If the shares are sold before the hold period is up, the investor must forfeit the tax credits that were previously claimed. Not only was the investment unsuitable , it created a serious liquidity problem because of its location in a RESP.

Other issues are occurring in RRIF accounts where DSC sold mutual funds are placed. Because of the minimum annual withdrawal requirement , DSC early redemption penalties are imposed upon redemptions. If Front -end load funds (or n0-load funds) had been sold to the investor, such penalties could have been avoided.

A final example occurs when advisors recommend investments that are not qualified for RRSP accounts. Not only would an investor be liable for taxes and back interest but would also be exposed to penalties from the CRA.