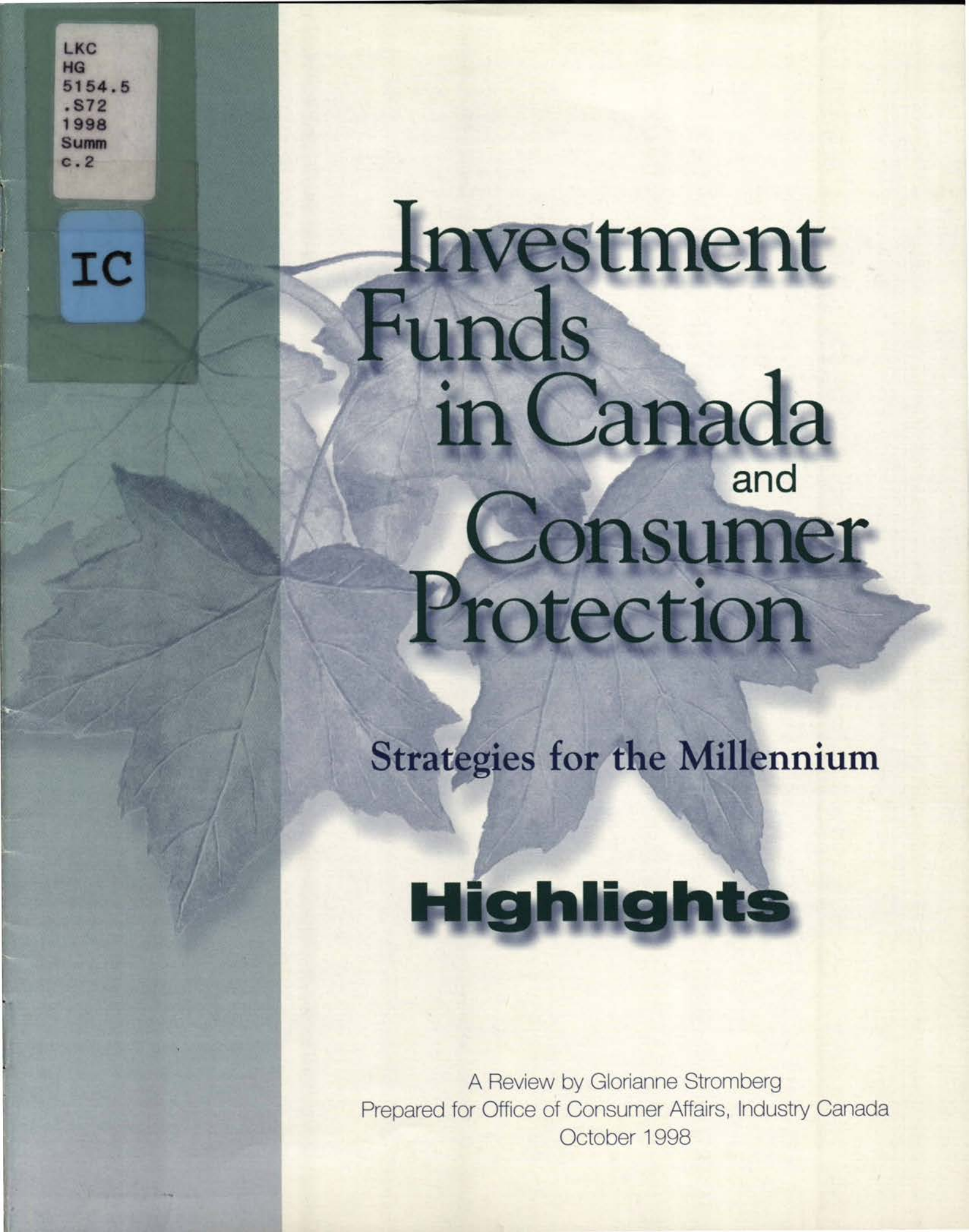


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# Investment Funds in Canada and Consumer Protection

Strategies for the Millennium

## Highlights

A Review by Glorianne Stromberg  
Prepared for Office of Consumer Affairs, Industry Canada  
October 1998

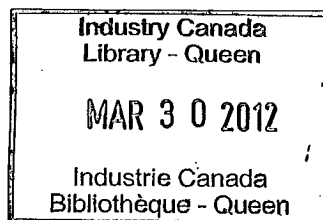
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# INVESTMENT FUNDS IN CANADA AND CONSUMER PROTECTION

## STRATEGIES FOR THE MILLENNIUM

A Review by Glorianne Stromberg

Glorianne Stromberg's *Investment Funds in Canada and Consumer Protection: Strategies for the Millennium*, a report commissioned by Industry Canada's Office of Consumer Affairs, is intended to stimulate discussion on how to improve consumer protection for the growing number of ordinary Canadians turning to investment funds as a means of saving for the future. This document highlights some of the major issues put forth in Ms. Stromberg's report. Interested readers are encouraged to review the entire report, which can be accessed on Industry Canada's *Strategis* Web site (<http://strategis.ic.gc.ca>) or obtained through Industry Canada's Information Distribution Centre.

### HIGHLIGHTS

The increasing popularity of investment funds as a means for Canadian consumers to improve the rate of return on their savings and as a source of retirement income, has fueled the growth of the investment funds industry, particularly in the past eight years. This, combined with strong market performance, has increased dramatically the number and type of investment funds, players and investors in this field.

Many "ordinary Canadians," who just a short time ago would not have been considered likely consumers of investment fund products, now look to these funds to provide for their future well-being.

The rapid expansion in the consumer investment market has outpaced the regulatory and supervisory system, and no one regulatory group or sector of the financial services industry, acting alone, has the mandate or authority to implement comprehensive solutions.

Given the importance and complexity of this industry, the evident lack of knowledge and expertise on the part of consumers, and the growing tendency to sell investment funds in the same manner as any other consumer goods, together with Canada's lack of common regulatory standards respecting investment funds and money management services generally, it is appropriate to consider what improvements would enhance investor protection and better meet the needs of consumer/investors.

This report identifies core problems that affect consumer protection. These problems are not unique to any type of institution within the sector, nor are they unique to any particular region of the country. They cross all boundaries. Canadian governments and industry should act together to deal with them.

Improving consumer protection requires action in several areas:

- better disclosure related to fees and other essential information;
- concerted efforts to improve the knowledge and awareness of consumer/investors;
- agreements among governments and key industry stakeholders leading to an integrated regulatory regime including appropriate self-regulation; and
- the modernization, simplification, coordination and harmonization of provincial and federal laws.

These approaches must be based on the assumption of leadership by those at the highest levels of industry and government, both federal and provincial.

## **1. INTEGRATION, SIMPLIFICATION AND RATIONALIZATION OF REGULATORY REQUIREMENTS**

***There is a need to integrate, simplify, streamline and rationalize regulatory requirements, to serve the needs of the marketplace and consumer/investors better.***

Prior to 1987, the structure of the financial services industry was characterized as resting on "four pillars": banks, trust companies, insurance companies and brokerages. There was a separate regulatory structure for each category, and institutions vied with each other for business from consumer/investors.

Notwithstanding the deregulation of the financial services industry that occurred in 1987, allowing firms within each pillar to deal, directly or indirectly, in all products and services, the current regulatory structure has continued to segment the financial services sector into the product lines that were provided by the four pillars. In addition, products, functions and the provision of advice have been integrated, while the regulatory structure remains segmented. The result is regulatory overlap with conflicting or inconsistent requirements in some cases, and regulatory gaps in others. There are concerns about the lack of common standards regarding the various investment alternatives available to consumers that are the functional equivalents of each other. Disclosure and registration requirements, know-your-client/suitability obligations, sales and business practice standards, education and proficiency requirements, and the degree of regulatory oversight all vary, as do consumer redress mechanisms.

Of prime concern is the fact that some investment alternatives (such as segregated funds, index-linked or market-linked universal life policies and other variable annuity contracts) are excluded from the definition of "securities" under securities legislation. The lack of a common regulatory regime, together with the lack of common standards

for investments and investment alternatives, increases the risk of consumer/investors being offered investments and other products that may not be suitable, or the best match, for their needs.

***The regulatory/self-regulatory structure does not coincide with marketplace reality, and there is a need to consider the effectiveness of the self-regulatory structure in the current environment. Continued segmentation, based either on the old four pillars, or on fragmented inter- or intra-provincial (or national) boundaries, appears increasingly outmoded.***

## **2. FUSION OF PRODUCT, FUNCTION AND ADVICE**

***It is difficult for consumer/investors to identify when they are being provided with independent advice, and when they are simply being sold a product which may be advice packaged as a product, a proprietary product, or a product in which the seller/adviser has a substantial financial interest.***

The focus of the financial services industry is on asset gathering, asset allocation services and asset management. This has led to substantial changes in the distribution side of the industry as it shifts from a transaction-based business to a fee-based, relationship-driven, financial services business. It has also led to substantial changes taking place on the advisory side of the financial services industry, as each industry player shifts to gain increased sales volume and market share.

The need to gain market share and protect income streams has resulted in the blurring, and in some cases the fusion, of product, function and advice. With this fusion has come a corresponding change of emphasis from the success of the transaction to the success of the portfolio. The traditional product sales-oriented representative has evolved into, or is being replaced with, a relationship-oriented, advisory-based manager, whose primary role is that of an intermediary between the client and internal or external money managers or experts.

Banks, insurance companies, trust companies, credit unions and independent mutual fund organizations, independent mutual fund dealers and full service investment dealers now offer, directly or indirectly, a full range of investment advisory services and products. Many of them, through equity interests in other segments or sectors of the financial services industry or through strategic alliances, have multiple entries in both advisory and distribution channels.

Intermediaries commonly portray themselves as providing financial planning and investment advisory services, but in reality are often only selling product. Compensation is linked to product sales, and the consumer/investor often fails to understand the implications of the situation. Knowledge gaps leave consumer/investors vulnerable.

***There is a need, therefore, to change registration and licensing requirements, which are still tied to the obsolete four-pillar model and are still centered around product sales, and to change education and proficiency requirements to improve the competencies and skills needed to provide financial planning and investment advisory services.***

### **3. COMMON REGIME FOR MONEY MANAGEMENT**

***There is a need for a uniform regime for all aspects of money management using a common regulatory or self-regulatory approach.***

This approach should involve **centralized, coordinated, streamlined and functional regulation**, including self-regulation, that is non-duplicative, and which could be achieved pursuant to intergovernmental agreements. The overall goal is an integrated regulatory and supervisory system that would focus on:

- prudential and solvency concerns that relate to various activities (such as banking, insurance and liability trading) of the respective institutions; and
- the advice-giving activities of intermediaries, with specific product knowledge being subsumed under the framework of advice-giving/distribution activities.

***A key component of the system would be the requirement for membership in a single self-regulatory organization whose requirements are focussed on the advice-giving activities of intermediaries who have available to them a full range of financial products and money management services to implement the advice.***

### **4. PROFESSIONAL COMPETENCIES AND THE NEEDS OF THE CONSUMER/ INVESTOR**

***When consumer/investors turn to a professional for advice they are entitled to expect that: advice will be based on a full client-needs assessment; the advice provider will have the capability to make such an assessment; the advice they are given will be in their best interest; and the advice, and the plan to implement such advice, will be based upon a full range of money management services and products being available to meet their goals and objectives.***

In order to meet these reasonable expectations, a fresh approach to education, proficiency and registration requirements is needed, which incorporates minimum standards of competency and professional conduct.

One of the most essential components of consumer protection relates to the adequacy of the education and training of the intermediaries who deal with the consumer/investor. These requirements should be based on what the intermediary is **actually** doing, and on an identification of the competencies and skills required for

such an activity. It is of the utmost importance to the consumer/investor that the identification of the requirements for this education and training begin without delay.

To this end, a non-partisan standards body should be established. This body would identify the key competencies needed by client-contact professionals, establish indicators to measure such competencies, develop a prototype curriculum, accredit courses and oversee examinations, and provide continuing education programs for graduates.

## **5. REDUCING THE KNOWLEDGE GAP**

***The single most important thing that could be done to benefit the consumer/investor would be to reduce the knowledge gap—the gap between those who know and those who do not. This knowledge gap usually operates to the disadvantage of consumer/investors, and usually results in their receiving too little value at too high a cost.***

Knowledge gaps leave consumer/investors vulnerable, and measures to enhance the knowledge and awareness of consumer/investors and to reduce the knowledge gap should be undertaken.

Enhanced knowledge and awareness could equip consumer/investors with the basic skills needed for informed decision making, including the ability to understand information that is communicated to them. It could empower consumer/investors to take charge of their own economic well-being.

**Disclosure** is one of the cornerstones of Canada's current regulatory and supervisory system, and it is also key to consumer protection. However, if disclosure is to lead to an effective consumer protection strategy, consumer/investors must learn how to use information to make sound decisions. Thus, disclosure is about more than documents. It is about having ready access to information and using it to make decisions effectively, with full understanding and comprehension of the significance (or lack of significance) of the information that is provided (or not provided).

Consumer/investors are looking for quality information, plainly and simply presented, that will help them make effective decisions either with or without the help of a third-party advisor. Such information should be timely, relevant, readily comprehensible and accessible. The industry should also provide more transparency in areas such as fees and charges, and portfolio holdings.

Relevant information should be identified and communicated clearly, and care should be taken to see that consumer/investors understand the relevance of this information to their situation. Common standards should be established to provide consumer/investors with full, true and plain disclosure of the material facts about their respective investment products. All relevant information should be required, or at



least permitted, to be included in one simple but complete offering document— **the fund prospectus**. This document should be required to be plainly and simply written in a non-repetitive manner. The complete offering document should be required to be actually delivered to investors **before** they invest.

**Know-your-client/suitability procedures** are an essential component of the disclosure requirement. These procedures require dealers and advisers to make the enquiries that will enable them to establish the identity, and, where applicable, the creditworthiness and reputation of each client. These procedures need to be adapted for use by dealers and advisers in maintaining an ongoing advisory-based relationship with clients.

A **confirmation/point-of-sale document** would also comprise an integral part of an effective disclosure system. This document would include information about the intermediary's fees and the impact of such fees on the consumer/investor's return over a number of years, as well as information about whether the fund is a proprietary or third-party fund, and whether it is CDIC (Canada Deposit Insurance Corporation) insured among other things.

The **account statement** is another essential element of disclosure, although it has not always been viewed as such in the past. It provides an important opportunity to answer the consumer/investor's most basic question, "How am I doing?" Consumer/investors should be able to use their account statements both to check on the accuracy of recorded transactions and to monitor whether their portfolio allocation is appropriate to their goals. In this respect, there is a need to develop measures to help consumer/investors understand how they are doing. These measures will help them evaluate how their objectives are being met, and whether modifications are needed.

Information is only effective when used in combination with other strategies, such as **consumer/investor education**, and where a competitive environment offers consumer/investors genuine choices. If consumers do not have the fundamental ability to understand and make use of the information that is communicated to them, **no** consumer protection remedies, particularly those based on disclosure, will work effectively.

There is a need to enhance the education system so that it can equip consumer/investors with the skills that would enable them to make effective economic decisions, and thus meet their goals and objectives. Heavy emphasis should be placed on educating consumer/investors (and their advisors) about the substantive differences among the different investment funds, and their suitability for a given consumer's needs. There is a need to put in place measures to ensure that present and future generations are equipped with basic life skills to function in today's world—and financial management skills are high on this list. Coordinated governmental action could marshal the forces necessary to bring about the needed changes.



Many factors are necessarily involved in improving the economic education of consumer/investors: the building of literacy and numeracy skills; the training of teachers to prepare students for economic life; the improvement of problem-solving abilities; curriculum design; and resources to support curriculum opportunities and teacher capability.

***The ultimate goals should be the creation of common standards to provide consumers with full, true and plain disclosure about their investment products, and the creation of a lifelong learning process, structured to enable Canadians, competently and with confidence, to make the basic economic life decisions they are called upon to make in their daily lives. Decisions about investing are only one aspect of these economic life skill decisions.***

## NOTES