



# Office of Consumer Affairs CONSUMER QUARTERLY

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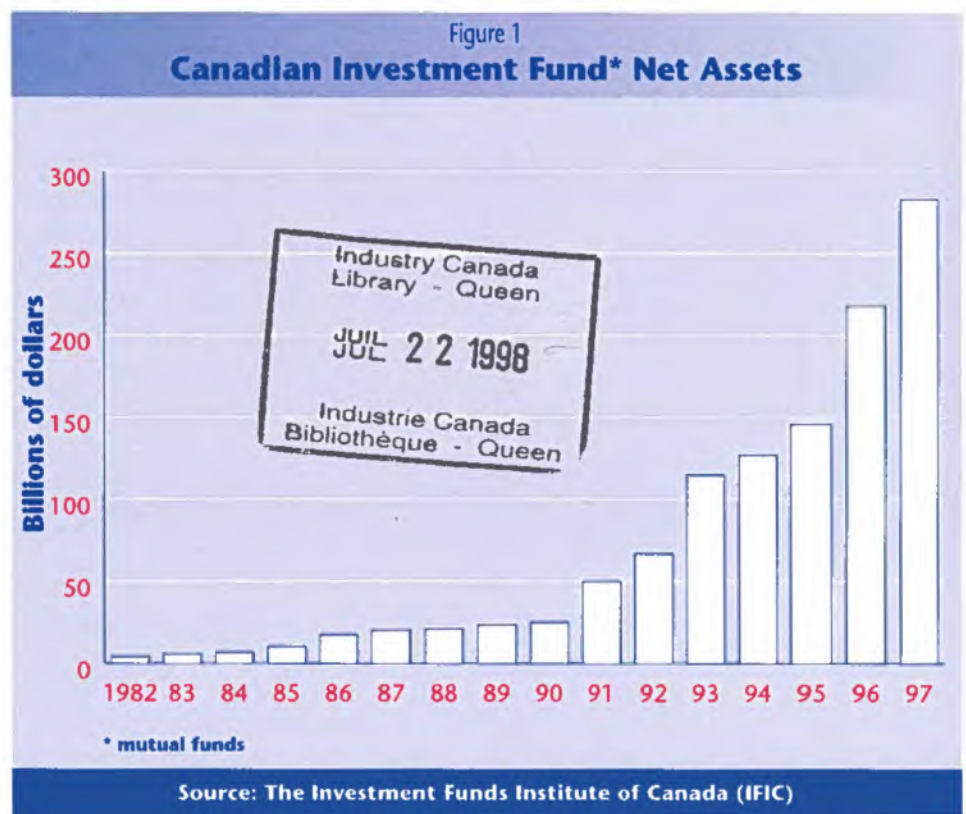
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## Mutual Funds: What to do?

The 1990s have seen an enormous shift in the savings and investment patterns of consumers. Primarily through mutual funds, many consumers have transferred their savings from safe interest-bearing instruments such as bank deposits and guaranteed investment certificates insured by the Canada Deposit Insurance Corporation to the riskier capital market, once the preserve of a small number of Canadians.

From the end of 1990 to December 1997, the net assets of Canadian mutual funds rose from slightly more than \$20 billion to around \$280 billion (a 1300 percent increase — see Figure 1). The growth in mutual fund assets will become even more pronounced as the bulk of the baby boomers move into the preretirement phase of their lives over the next decade. A Gallup Poll conducted for Investors Group suggested that as much as \$1 trillion will pass to baby boomers from their parents in the next 20 years. Much of this windfall will likely be invested or reinvested in capital markets, particularly to prepare for retirement.

While Canada's provincially based securities regulatory system is one of the strongest in the world, the rapid growth and the changing structure of the mutual fund



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industry pose significant challenges for regulators, industry associations, provincial securities commissions and consumers themselves. The seven-year long bull market, which has brought strong

returns for mutual fund holders, may have masked the importance of these challenges. How well is the system working and how well can it adapt to the rapidly changing marketplace?



# Why are Consumers Taking More Risk?

Several developments have influenced Canadian savers to accept more risk.

- Relatively low interest rates on bank deposits, Canada Savings Bonds and guaranteed investment certificates have prompted investors to search for higher yields elsewhere. Interest rates that were in the high teens in the early 1980s are in low single digits today.
- With lifetime careers with a single employer becoming less common, fewer

individuals than previously can depend solely on an employer's pension plan to finance their retirement.

- Reforms of the tax system, most notably the introduction of registered retirement savings plans (RRSPs), have encouraged individuals to save for their retirement themselves. Even planned reforms to the Canada and Quebec pension plans (CPP/QPP) have not reduced public doubts about the sustainability and sufficiency of retirement income from these sources.
- Demographic trends are an important contributor to the growth of the mutual fund industry. The majority of Canadian baby boomers have not yet reached the financial investment stage of their life cycle (see Figure 2). Most are still paying off their mortgages and other debts; however, when they do reach the financial investment stage, more and more, looking forward to early retirement and longer life expectancy, will seek higher investment returns by assuming more personal risk.
- Finally, there has been a slow but consistent trend away from defined benefit

employee pension plans, in which the amount a person receives in retirement is determined by years of service and average salary. Some employers are opting instead for defined contribution plans, in which the pension a person gets depends on the plan performance. Recognizing that the risk has already been shifted from their employer to themselves, employees may opt for higher yielding investments.

*"The public also needs to know about the way you [the mutual fund industry] work, the way you are accountable to your unit holders, and how various types of business costs are passed on to your customers. The public needs to know these things because we live in an age where people are demanding not only more information, but also more accountability from their institutions..."*

*Honourable Michael J.L. Kirby,  
Chairman, Standing Senate Committee  
on Banking, Trade and Commerce, in an address  
to the Investment Funds Institute of Canada*

## Consumer Education

Consumers clearly bear a responsibility for informing themselves about their investments. Investment guides are widely available and industry associations are making efforts to improve investor education. However, much ground remains to be covered. For example, a recent survey by the Canadian Bankers Association found that 28 percent of mutual fund investors believe that their funds are insured much as deposits at a financial institution are.

Figure 2

### Population Peak Moves into Financial Asset Accumulation Stage in Eight Years



Source: Statistics Canada

# Consumer Investment Issues

**C**onsumer knowledge is a key issue for the mutual fund industry. Large numbers of new and, therefore, inexperienced buyers are entering the mutual fund market, often encouraged by intense advertising. Mutual funds have increasingly become a consumer product so the related marketing efforts highlight benefits and downplay risks. While consumers are protected by systematic and comprehensive industry disclosure rules, it can still be difficult for individuals to assess the price they are paying for investments, the degree of risk they are taking and the availability of redress if sales practices are unacceptable.

In February 1994, the Canadian Securities Administrators (see page 4) asked Ontario Securities Commissioner Glorianne Stromberg to examine the need for changes to the way mutual funds are regulated and the manner in which securities are offered for sale. Her report raised a number of problems consumers have encountered when seeking financial advice, planning for retirement or purchasing mutual funds. Since the report was published, the industry has made substantial efforts to deal more effectively with these kinds of consumer issues. But problems, such as those listed below, persist.

## Prices and Cost

Fees associated with mutual funds can be complex due to their ongoing nature and variety — they cover sales, management, advertising, administrative and various operating costs — and the differences from one type of distributor to another. Many consumers may not understand the extent of costs arising from regularly paying these fees, and given the complexity of fee structures, they may find it difficult to comparison shop for the best deal. In addition, it may not be clear to consumers how they are paying, to whom and for what. For example, sales commission amounts may not be transparent and it may not be evident that mutual fund marketing costs can make up a large component of a management fee.

## Quality

Consumers find that the performance of their holdings is difficult to relate to the reported performance of their funds. Comparing performance between funds can also be difficult, since there are few established standards for performance reporting. For example, there are several ways of calculating a simple average. Just a fractional difference could have a large effect on measured performance over a long period of time.

## Risk

While consumers are usually asked about their tolerance for risk before purchasing a fund, products may not be as safe or as secure as professed. The emphasis in promotional material is on fund performance as measured by yields, but most funds do not report risk-adjusted returns for their products and there are no common industry standards for doing so.

## Redress, Compensation and Dispute Settlement

There are few effective mechanisms available for consumer redress, compensation and dispute settlement. Consumer problems in this area range from outright fraud to the incompetence of those giving financial advice. The media has reported instances of conflicts of interest when dealers and managers are allowed to trade for their own personal accounts or when providers of services to the fund act on their inside knowledge. Consumers can expect higher levels of protection when buying from firms that belong to a self-regulating organization. However, about half of Canadian mutual fund sales go through mutual fund distributors who are not members of this type of organization and consumers may not know the difference.

## Consumers Face an Uneven Regulatory Structure

**A**re funds provided by different industries afforded equal regulatory oversight and protection? Is securities industry regulation adequate to protect consumers?

Although the sale of any mutual fund is regulated by provincial securities commissions, such funds can be distributed by any of the four pillars of the Canadian financial sector: chartered banks, trust companies, life insurance companies and investment dealers. These organizations are, in turn, governed by different rules set by different regulatory bodies. Also, the funds themselves may sell their products directly to the public through their agents. It should be noted that the federal government has no direct role in regulating the securities industry even though it is responsible for regulating the banking sector.

Some industry participants have complained that it is unfair for products to be regulated differently depending on who is selling them. Industry participants in a sector that adheres to a code of good conduct may be at a competitive disadvantage to those in another sector that does not follow such a code.

Outside of Quebec and British Columbia, anyone in Canada who wants to call himself or herself a financial planner can do so. The *Financial Post* estimated that more than 25 000 Canadians use the title financial planner, while the Financial Planning Standards Council of Canada acknowledges that there are only about 5200 Certified Financial Planners in the country.

The overriding question appears to be whether there should be a stronger fiduciary responsibility between distributor and buyer that goes beyond the current emphasis on selling over advising.

# Progress to Date

## The Investment Funds Institute of Canada (IFIC)

IFIC reviewed and responded to the Stromberg report with *Recommendations for a Code of Practices of the Mutual Fund Industry* in 1996. Principal among the recommendations is the reduction or elimination of incentives provided by fund companies to sales agents that may create a conflict between the interests of the agent and those of the investor. The recommendations outline how funds should provide investors with more and clearer information about sales charges and agent compensation. IFIC did not adopt the recommendations for the code, but asked the Canadian Securities Administrators (see below) to take the necessary steps to

require all persons selling mutual funds to comply with its requirements.

## Canadian Securities Administrators (CSA)

The CSA, which includes all of the provincial and territorial securities commissions in Canada, has taken steps to regulate the sales practices of mutual fund suppliers and distributors. National Instrument 81-105, which is based on IFIC's voluntary code and comparable rules of the Investment Dealers Association of Canada, came into force on May 1, 1998.

## The Canadian Institute of Chartered Accountants (CICA)

The CICA released its study, *Financial Reporting by Investment Funds* in September 1997 in an attempt to develop common accounting standards for all forms of investment funds. In addition to setting out rules on how the funds should keep their books, the CICA also developed standards for the following:

- reporting information on fund performance
- management policy
- risk disclosure
- how fees and expenses are charged to the fund.

As part of this report the CICA carried out a survey of the reporting practices of 12 mutual fund organizations, encompassing 115 funds. Measured against CICA recommendations, the reporting of key information was quite mixed. For example, 10 of the 12 funds reported management fees, five reported directors' fees, and only one reported distribution expenses. The industry and regulators are considering their responses to this report.

## The Standing Senate Committee on Banking, Trade and Commerce

This committee held hearings in mid-November 1997 on the role of institutional investors in Canada's financial system. Certain testimony pointed to the important links between the three cornerstones of retirement income: minimum income support provided by CPP/QPP, the voluntary tax-sheltered sector, comprising RRSPs and employer-provided pension plans, and individual savers investing in the financial markets through the mutual fund industry. Forthcoming recommendations to improve the accountability of these cornerstones are expected to benefit consumers.

## For further information

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## What Next?

**M**any consumers remain ill-informed about mutual funds despite the volume of information available and the strict requirements for clear disclosure being met by the industry. A challenge for the industry is how best to convey to consumers in a clear and simplified fashion the most essential information: who can sell mutual funds, how are they sold, and what is the relationship between distributor and consumer.

The problem of consumer information is fairly typical for a rapidly developing market selling complex products. The urgency of the issue lies in the importance of these products to the future security of retirement income for a generation of consumers.

The Office of Consumer Affairs recently asked Ontario Securities Commissioner Glorianne Stromberg to prepare a report

on progress in consumer protection since her study was released. One of the principal goals of the report is to recommend measures that will reduce the information gaps between buyers and sellers. Of particular concern are the following:

- ensuring that consumers understand the significance of information provided to them
- ensuring that investors seeking financial advice from a professional obtain advice and not a disguised sales pitch
- ensuring that funds disclose all fees and incentives provided to sales agents.

Addressing these issues will go a long way to ensuring that the investments of an increasing number of Canadians are sound and based on informed choice.