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INVESTIGATION REPORT

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

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INVESTIGATION SUMMARY

Investment Advisor:	▪ Mr. C	
Issue:	▪ Suitability of investments	
Products:	▪ Alternative Strategy (Hedge) Fund ▪ Labour Sponsored Fund ▪ Mutual Fund	
Period:	▪ April 2007 to March 2010	
Key Conclusions:	▪ Ms. B was a balanced investor with 60% lower-risk fixed income and 40% medium-risk growth objectives. ▪ Mr. C recommended unsuitable high-risk investments to Ms. B and she incurred losses as a result. ▪ Mr. C understated the risks of the investments he recommended to Ms. B. She had only fair investment knowledge and did not know she was unsuitably invested. ▪ CFC is responsible for compensating Ms. B for the losses she incurred.	
Recommendation:	$52,909	Compensable losses from unsuitable investments
	$1,382	Interest on recommendation
	$54,291	Total recommendation

OVERVIEW

Ms. B began investing with CFC in April 2007. She was 67 years old at the time and semi-retired. She still had a modest income from her hairdressing business and some government pension income. She expected to fully retire by age 71. She had only fair investment knowledge and completely relied upon Mr. C for investment advice.

Mr. C invested Ms. B's entire portfolio into high-risk investment funds that were not suitable for her given either her willingness or ability to accept risk. Mr. C did not make a diligent effort to understand the risks of the investments he recommended and inaccurately categorized them as low-medium risk, when they were in fact high-risk investments. Mr. C also recommended a 100% growth portfolio, which was unsuitable for Ms. B given her financial circumstances. Rather, she should have had at least 60% of the account in lower-risk, fixed-income investments.

Ms. B incurred $52,235 in losses as a result of the unsuitable high-risk investments. We determined that she would have gained $674 with a more suitable mix of lower-risk, fixed-income investments and medium-risk, equity investments. Therefore, we are recommending that CFC and Mr. C compensate her for the difference of $52,909 plus interest.

BACKGROUND

- Mr. C was the founder, President, and sole director, compliance officer, and investment advisor of CFC.

- On April 23, 2007, Ms. B opened non-registered, RRIF and RRSP accounts with CFC.

- On May 14, 2007, she transferred $35,711of the Mackenzie Ivy Growth and Income Fund (Growth & Income Fund) in kind to her RRIF account.

- On June 21, 2007, she transferred $8,911 of the Growth & Income Fund and $58,499 of the Mackenzie Sentinel Money Market Fund (Money Market Fund) in kind to her RRSP account.

- On June 30, 2007, the total market value of Ms. B's RRIF and RRSP accounts was $102,200. Between May 2007 and August 2009, Ms. B received payments from her RRIF which were reinvested in a labour-sponsored fund.

- Between June and December 2007, Mr. C recommended Ms. B sell her previous investments and purchase three other investments: a high-risk sector mutual fund, a high-risk hedge fund and a high-risk, illiquid labour sponsored investment fund.

- Ms. B said she complained to Mr. C about her accounts in early 2009. On August 24, 2009, she transferred all her RRSP and part of her RRIF, totaling $34,534, in kind to another firm. She sold these investments shortly after transferring them away from CFC.

- The hedge fund and the labour sponsored fund remained in her non-registered account at CFC. Ms. B said that she did not transfer these out because she could not redeem these investments.

- The total value of her transfer outs and the remaining balance in her accounts was $50,031 as of August 24, 2009, for a loss of more than $50,000 ($102,200 - $50,031) over the two years she invested with Mr. C.

COMPLAINT

On February 16, 2010, Ms. B wrote to the MFDA to complain. In her letter she said that:

- when she met with Mr. C in July 2007, she made him aware that she was a risk-averse investor;

- Mr. C did not advise her, and she was unaware, of the risks associated with the Working Opportunity Fund or that the fund would be locked in for a period of time;

- in researching Mr. C's investment choices, she was shocked that they were extremely aggressive funds, very unsuitable for her and were not at all as represented by Mr. C; and

- she was assured that her investments were conservative in nature and the strategies employed would help meet her retirement goals.

Ms. B did not indicate what compensation she was seeking, but said that no "conservative" investment should disappear at the rate hers did.

CFC'S RESPONSE

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

- the Working Opportunity Fund has proven to be a low-volatility investment that meets and exceeds Ms. B's investment mandate and he considers the investment suitable for her;

- he recommended the Mackenzie Cundill Emerging Markets Fund because Ms. B said she wanted a strong, growth-oriented portion in her portfolio and, based on the information available at the time, he "reasonably considered the portfolio of this fund to be suitable"; and

- based on information available at the time of her investment in the Mackenzie Alternative Strategies fund, he “reasonably considered the portfolio of this fund to be a low-volatility (4.2 Standard Deviation) low to moderate risk investment” with an opportunity for positive returns in a low interest rate environment.

CFC did not offer compensation.

OBSI ANALYSIS

In the course of our investigation, we reviewed correspondence between Ms. B and CFC, various account applications, disclosure forms and account statements. In addition to interviewing Ms. B 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. B’s complaint:

1. What were Ms. B’s personal and financial circumstances, investment knowledge and experience, risk tolerance and investment objectives?

2. Were Ms. B’s investments suitable?

3. If Ms. B’s investments were unsuitable, did she suffer financial harm as a result?

4. Should Ms. B share responsibility for her losses?

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

- Ms. B signed a single pre-printed Client Data Form when she opened her accounts with CFC in 2007.

Table 1: Client Data Form completed on April 23, 2007

Investment Objectives	Growth: 100%
Investment Experience	Common Stock and Mutual Funds
Investment Knowledge	Good
Volatility	13 to 18
StdDev	Average
Annual Income	$29,323
Net Worth	$441,000
Fixed Assets	$400,000
Liquid Assets	$17,000
Other Investments:	$101,740

Personal and Financial Circumstances

- Ms. B was 67 years old when she opened her accounts with CFC in 2007 and had been semi-retired since 2005. Ms. B confirmed that she had $29,323 in income as shown on her Client Data Form, consisting of income from her hair dressing business and Canadian Pension Plan (CPP) and Old Age Security (OAS) payments.

- Ms. B indicated that her only fixed asset was her home, but she did not know if it was worth $400,000 in 2007 as was recorded on the Client Data Form. She said her liquid assets of $17,000 was cash in her business bank account and her other investments of $101,740 was the money she invested with CFC. She said she had no other investments or assets. Although the Client Data Form showed a total net worth of $441,000, total assets listed on the form add up to a net worth of $518,740. It is possible that the value of her home was overstated. In any case, her investment assets of $101,740 and liquid assets of $17,000 were accurately recorded on the Client Data Form.

- In 2007, Ms. B was in her late sixties and had a modest income and very little savings. Aside from her home and the small amount of cash in her business account, all of her investments were with Mr. C and she had no other assets. In 2007, she was semi-retired and expected to fully retire within three years.

Investment Knowledge and Experience

- Ms. B's Client Data Form showed her investment knowledge as "Good."

- In her letter to the MFDA, Ms. B said that she was unhappy with her previous financial advisor because she had more losses than gains and decided to transfer her accounts to Mr. C. During our interview, Ms. B said that before moving to Mr. C, she was invested in mutual funds, but might have held some stocks and bonds when she was in her 50s. She said that her investments were always based on what her advisors recommended. Ms. B does not agree her investment knowledge was "good" because she never picked her own investments and always relied on her advisors or friends to suggest investments.

- Ms. B said she understood that her investments fluctuated in value, that mutual funds are not guaranteed investments like bonds and that unless it is a Canada Savings Bond, there is risk in investments.

- Mr. C said that before transferring her accounts to CFC, Ms. B was picking her own individual stocks and mutual funds so he assessed her investment knowledge as "good". However, Mr. C has no notes documenting his discussions with Ms. B and there is no evidence to support Mr. C's claim that she was picking her own investments before transferring to him.

- The investments Ms. B transferred to CFC were predominately low-risk and low-medium risk mutual funds. Less than 5% of her account was invested in two higher-risk stocks which she said were recommended by friends.

- Based on our discussions with Ms. B, we found that her investment knowledge was "fair" at most in that she understood the difference between a stock and a bond and understood that mutual funds and stocks could fluctuate in value. But she could not describe the characteristics or risks of the investments she held. Neither her background nor investment experience would have given her "good" investment knowledge and we cannot accept the Client Data Form as being accurate in this regard.

Investment Objectives and Risk Tolerance

- Ms. B's Client Data Form indicates an investment objective of 100% growth.

- During our interview, Ms. B said her investment objective was retirement income. While she said that in 2007 her income generally covered her expenses and she was not planning to start drawing down her principal until she turned fully retired at 71 (three years later in 2010), she says she was not taking many hair dressing appointments by 2007 and wanted the interest or distributions from her investments to supplement her income if needed.

- Mr. C said that Ms. B did not need income from her account. His note from a meeting with Ms. B on July 30, 2007 said "She didn't need income from her portfolio, so she wants to continue to invest for growth". This was the only client file note provided by Mr. C and he said he did not have any other client file notes for Ms. B.

- CFC's Client Data Forms did not specifically refer to risk tolerance. Instead, they referred to "Std Dev" and "Volatility". On Ms. B's Client Data Forms, her "Std Dev" was recorded as "average" and her "Volatility" was recorded as "13 to 18". 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, we believe Ms. B's Client Data Forms indicated a medium risk tolerance level.

- While Ms. B says she understood there was some risk with investing, she says that she was not willing to take average, or medium risk. She said she had worked 47 years to save her money and since she was going to retire soon, she could not afford to take a lot of risk. She says that based on Mr. C's explanations, she thought he was recommending below average risk investments that would also pay interest or distributions to supplement her income if she needed it. This is consistent with what Mr. C explained in his written response to Ms. B's complaint. In his letter to her he described the Working Opportunities Fund and Alternative Strategies Fund as being low-volatility, low-moderate risk investments.

- Ms. B provided us with copies of her investment statements from her previous investment firm showing her investments before she transferred to Mr. C. Consistent with Ms. B's suggestion that she was not willing to take a lot of risk, the April 30, 2007 statement from her previous investment firm shows she had about 40% of her portfolio in low-risk cash and money market funds, 44% in a low-medium risk balanced fund, 12% in a medium-risk equity fund and about 4% in two higher-risk stocks.

Conclusion

Ms. B had only fair investment knowledge and relied on Mr. C for investment advice. She needed her modest investments to provide her with income as required before she retired and to supplement her government pension income when she fully retired in just three years time. 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-risk growth objective was accurate.

Rather, like with her previous investments, it would have been reasonable for Ms. B to invest up to 40% of her money in medium-risk equity investments to protect her investments against inflation and to provide her with an opportunity for growth to meet any increasing health or other expenses she may have over the long term, with the remaining 60% in lower-risk fixed income investments. Such a portfolio is often referred to as a "balanced" portfolio and, since she was 67 years old, it would be generally in line with the guideline that an investor should not allocate a percentage to equities greater than 100 minus their age. Therefore, we assessed Ms. B's investments against these risk and investment objective parameters.

Issue 2 – Were Ms. B's investments suitable?

- After Ms. B transferred her accounts to CFC, Mr. C recommended and reinvested her accounts into three investments: Mackenzie Cundill Emerging Markets Fund, a high risk mutual fund, Mackenzie Alternative Strategies Fund, a high risk hedge fund, and Working Opportunity Fund Commercialization Shares, a high risk labour-sponsored investment fund.

- As a result, after transferring her previously low to medium-risk, balanced portfolio to CFC, Ms. B was 100% invested in high-risk growth-oriented funds that were entirely too risky and not at all suited to her personal and financial circumstances or 60% lower-risk income and 40% medium-risk growth objectives.

- The primary disclosure document for mutual funds is the simplified prospectus and the primary disclosure document for hedge funds is the offering memorandum. These are the documents we used to determine the risks of the investments Mr. C recommended to Ms. B. The Emerging Markets Fund is described in its simplified prospectus as suitable for investors who "have a high tolerance for risk and are intending to invest in the Fund over the long-term. 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". Finally, the Working Opportunities Fund is described as "suitable for investors seeking long term capital appreciation, who have high tolerance for risk, and are willing to hold the investment for at least eight years".

- Mr. C told us that he does not use simplified prospectuses or offering memorandum to determine an investment fund's risk but instead relies on the investment fund's standard deviation to determine its risk. He said that based on their standard deviations, all of the investment funds he recommended to Ms. B were average risk or lower and therefore suitable for her.

- Standard deviation measures the variability in the historic returns of an investment or portfolio relative to its average return as a means 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 labour sponsored investment funds, such as the Working Opportunities Fund, or hedge funds, such as the Alternative Strategies Fund, which are not regularly priced. In any event, Mr. C could not provide us with any evidence that he had determined the standard deviation of these funds before recommending them to Ms. B.

- Standard deviation is also not a good measure of risk for investments with a track record of less than three years. We note that the Emerging Market Fund inception date was April 2007, only a few months before Mr. C recommended it to Ms. B, so standard deviation data for this fund would not have been available when he recommended it to Ms. B.

- Given Mr. C's entirely inaccurate assessment of the investment funds he recommended, he could not have accurately disclosed or explained the risks to Ms. B. In fact, we find it clear that she did not know her investments were high-risk and, given her limited investment knowledge and her reliance on Mr. C, we do not believe she could have independently determined their risks or characteristics. Rather, she relied on Mr. C's assurance that they met her needs.

Conclusion

The investment funds that Mr. C recommended to Ms. B were all high-risk, growth-oriented investment funds and therefore entirely unsuitable for her personal and financial circumstances and 60% lower-risk income and 40% medium-risk growth objectives.

Mr. C did not understand the risks of the funds he recommended and therefore did not accurately disclose the risks to Ms. B.

Issue 3 – If Ms. B's investments were not suitable, did she incur financial harm as a result?

- To determine if Ms. B incurred financial harm as a result of the unsuitable high-risk investments, we compared their performance to a suitable portfolio allocated 60% to the DEX Universe Bond Index (DEX) to represent the performance of lower-risk fixed income investments and 40% to the S&P TSX Composite Total Return Index to represent medium-risk growth investments. We adjusted the performance of the index to account for the mutual fund expenses that Ms. B was likely to have incurred in suitable mutual funds. Our calculations ran from June 2007, when the first high-risk investment was purchased, to September 24, 2012. The Alternative Strategies fund was eventually liquidated by the issuer on June 18, 2010 for $8,751. Ms. B still holds and cannot sell the illiquid labour-sponsored fund. We also accounted for the timing of her 2009 redemptions and her RRIF withdrawals.

  While Ms. B lost $52,235 on the unsuitable high-risk investment funds that Mr. C recommended, we calculated that she would have gained $674 if she had invested the same money in suitable investments. Therefore, the financial harm she incurred as a result of the unsuitable investments Mr. C recommended is $52,909 ($52,235 + $674).

Issue 4 – Who should bear responsibility for Ms.B's losses?

- In this case, Mr. C allowed Ms. B's accounts to be unsuitably invested contrary even to the inaccurate KYC information Mr. C recorded for her accounts.

- From Ms. B's perspective, she believed that Mr. C had made investment recommendations that were suitable for her needs and circumstances. Mr. C described the high-risk funds he recommended as low or medium risk. Ms. B's investment knowledge was only fair. She did not have the ability to independently assess the risks of the investments Mr. C recommended, she relied upon him for advice and she would not have known that the funds Mr. C described as low and medium risk were actually high risk.

- 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."

- Ms. B did not realize her investments were unsuitable and relied on Mr. C's assessment of the risks and determination that they were suitable.

- 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. B's investments were suitable for her.

- It does not appear to us that there is any basis to impose responsibility Ms. B, 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. B $52,909 plus interest of $1,382[1], for a total of $54,291.

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[1] Interest is calculated using the average 3-month Canadian Treasury Bill yield of **0.84**% (as calculated by the Bank of Canada) compounded annually to the date OBSI's report is final.