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INVESTIGATION REPORT

Date: March 21, 2013
Clients: Mr. H and Mrs. H
Firm: Connor Financial Corporation (CFC)

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INVESTIGATION SUMMARY

Investment Advisor:	▪ Mr. C	
Issue:	▪ Suitability of investments	
Products:	▪ Alternative Strategy (Hedge) Funds ▪ Mutual Funds	
Period:	▪ December 1991 to September 2010	
Key Conclusions:	▪ Mr. and Mrs. H relied on their investments to provide them with income when they needed it. Given their personal and financial circumstances they could not afford to take significant risks with their investments. ▪ The medium-high and high-risk investment funds Mr. C recommended to Mr. and Mrs. H were unsuitable for them and they incurred losses as a result. ▪ Mr. C understated the risks of the investments her recommended to Mr. and Mrs. H. They had little investment knowledge and did not know they were unsuitably invested. ▪ CFC is responsible for compensating Mr. and Mrs. H for the losses they incurred.	
Recommendation:	$185,516 $5,167 $190,683	Compensable losses from unsuitable investments Interest on recommendation Total recommendation

OVERVIEW

Mr. and Mrs. H were 61 and 51 years old respectively when they began investing with Mr. C in 1991. They were 79 and 69 years old when they transferred their investments away from Mr. C in 2009.

Mr. and Mrs. H had a modest income and net worth. They were relying on their investments to provide them with income during their retirement when they needed it. Their financial circumstances meant they could not take significant risk with their investments. Given their investment objectives and risk tolerance, the medium-high and high-risk equity mutual funds, and high-risk hedge funds that Mr. C recommended were unsuitable for them. They should not have held any higher-risk investments. Instead, along with medium-risk equity mutual funds they should have held lower-risk, fixed income investments.

Mr. C did not recognize and consequently did not adequately disclose the risks of the investments he recommended to Mr. and Mrs. H. We found that Mr. and Mrs. H had little investment knowledge, relied entirely on Mr. C's advice and would not have realized that the investments he recommended were unsuitable for them.

We calculate that Mr. and Mrs. H incurred compensable losses of $185,516 as a result of Mr. C's unsuitable recommendations. We are recommending that CFC compensate Mr. and Mrs. H this amount plus interest.

BACKGROUND

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

- Mr. and Mrs. H were 61 and 51 years old respectively when they began investing with Mr. C in 1991. Mrs. H retired in 1989 but continued working part-time earning a few thousand dollars each year. In time, she received Canada Pension Plan and Old Age Security payments. Mr. H retired in 1992 after which he started receiving Canada Pension Plan and Old Age Security payments. Mr. and Mrs. H had no other income.

- Mr. and Mrs. H say that in late 1991 they sold their home in Ontario for $375,000, invested $300,000 in a joint non-registered account with CFC and used the remaining proceeds to purchase and renovate a smaller and older "fixer-upper" in Victoria, B.C. Other than their home and their investments at CFC, they had no other assets.

- Between December 1991 and December 2002, Mr. H opened non-registered and RRIF accounts, and Mrs. H opened non-registered, LIRA and RRSP accounts with CFC. Mr. and Mrs. H did not invest any additional money with CFC but instead transferred investments from their joint non-registered account into these accounts.

- Mr. C was unable to provide us with any account statements for Mr. and Mrs. H. Mr. and Mrs. H could only provide us with a few account snapshots they received from CFC for October 2005, March and April 2006, and June 2008. We were able to obtain partial transaction histories directly from the mutual fund companies for December 1991 to December 2002. We believe the mutual fund company statements we were able to obtain for December 2002 to May 2009 are complete.

- The information from the mutual fund companies indicates that Mr. and Mrs. H initially held a mix of bond, balanced, and equity mutual funds that ranged from low- to high-risk. Over time, the Mr. and Mrs. H's portfolio became increasingly risky and by 2002, Mr. and Mrs. H no longer held any bond funds.

- By December 31, 2002, the total value of Mr. and Mrs. H's portfolio was $401,745. On that date, Mr. C sold a number of mutual fund units to purchase $118,119 of several high-risk hedge funds in Mr. and Mrs. H's accounts. On April 29, 2005, Mr. C switched an additional $10,660.70 in mutual fund units into one of the same hedge funds in Mrs. H's LIRA.

- Starting in June 2005, Mr. and Mrs. H withdrew up to $1,000 annually in RRIF payments from their accounts to supplement their income.

- In March and April of 2009, Mr. and Mrs. H began transferring their accounts away from CFC, in kind. The total market value of their investments at the time of transfer was $192,937.

MR. AND MRS. H'S COMPLAINT

On April 7, 2009, Mr. and Mrs. H's son complained to CFC on their behalf saying:

- CFC put all of Mr. and Mrs. H's liquid capital into three risky Mackenzie funds: approximately 70% in the Alternative Strategies Fund and a total of approximately 30% in the Mackenzie Cundill Emerging Markets Value Fund (Emerging Markets Fund) and the Mackenzie Cundill Recovery Fund (Recovery Fund);

- the Alternative Strategies Fund is a hedge fund that is at the top of the charts for risk in Canada and is typically reserved for high net worth, experienced investors;

- the Emerging Markets Fund and Recovery Fund are very high risk and meant for savvy investors; and

- other investments, such as the Abria Alternative Investments Fund, were also funds for sophisticated investors.

Mr. and Mrs. H asked to have their initial $300,000 investment restored plus $2,000 per year for commissions and trailers they paid in lieu of the gains they might have earned in more appropriate investments.

CFC'S RESPONSE

In his response letters to Mr. and Mrs. H of January 12, 2010 and July 7, 2010, Mr. C said:

- the Alternative Strategies Fund was "judiciously chosen" for Mr. and Mrs. H specifically for its "demonstrated ability and history of protecting capital in difficult declining markets during a period of time when yields on fixed income securities of similar low volatility were paying such low returns";
- as of September 2008, the Alternative Strategies Fund had a standard deviation of 4.0 and in earlier years it was 3.7, which "is approximately equal to that of a portfolio of Government Bonds";
- in 2001 and 2002, when markets fell over 40%, Alternative Strategies Fund showed positive returns and controlled volatility, which are just a few of the reasons that Alternative Strategies Fund "was **used for risk mitigation**" (Mr. C's emphasis); and
- the Recovery Fund was a key equity position in Mr. and Mrs. H's portfolio and has rebounded over 90% from its March 2009 low.

CFC did not offer compensation.

OBSI ANALYSIS

In the course of our investigation, we reviewed correspondence between the clients and the firm, various account applications and disclosure forms and account statements. We interviewed Mr. and Mrs. H regarding the complaint. Mr. H participated in the call, but now suffers from dementia, so Mrs. H responded to all of our questions. We also interviewed Mr. C. In addition, we have considered the applicable industry rules, regulations and practices.

OBSI examined the following key issues in respect of Mr. and Mrs. H's complaint:

1. What were Mr. and Mrs. H's personal and financial circumstances, investment knowledge and experience, and risk tolerance and investment objectives?

2. Were Mr. and Mrs. H's investments suitable?

3. If their investments were unsuitable, did Mr. and Mrs. H suffer financial harm as a result?

4. Should Mr. and Mrs. H share responsibility for their losses?

Issue 1 – What were Mr. and Mrs. H's personal and financial circumstances, investment knowledge and experience, and risk tolerance and investment objectives?

- Investment advisors are required to use diligence to ensure 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. To meet this obligation, investment advisors must obtain timely and accurate KYC information.

- Mr. C says he is unable to provide us with any documented KYC information prior to December 2002 because the system he used for documenting KYC information overwrote previous KYC information and he did not keep paper copies of the Client Data Forms the system generated. However, Mr. C was able to provide paper copies of Client Data Forms dated December 11, 2002, November 12, 2003 and April 25, 2005. We note that in each case Mr. C had Mr. and Mrs. H sign one Client Data Form for all their accounts.

Personal and Financial Circumstances

- When they opened their accounts with CFC in 1991, Mr. H was 61 years old and Mrs. H was 51 years old.

- The Client Data Forms Mr. and Mrs. H signed show the following income and net worth information:

Table 1: Income and net worth information on the Client Data Forms

	December 2002		November 2003		April 2005	
	Mr. H	Mrs. H	Mr. H	Mrs. H	Mr. H	Mrs. H
Annual Income	$17,214	$3,200	$17,214	$3,200	$15,000	$10,000
Net Worth	$650,000		$652,000		$741,000	
Fixed	$350,000		$350,000		$400,000	
CFC	$279,088		$300,075		$300,075	
Liquid	$20,000		$2,000		$1,400	

- Mrs. H semi-retired in 1989, but continued working part time earning a few thousand dollars per year doing desktop publishing. Mr. H retired in 1992. Mrs. H said that before he retired, Mr. H was self-employed doing home renovations and home inspections. She said his income was irregular and he did not have a "proper" pension. After they retired, they each received Canada Pension Plan (CPP) and Old Age Security (OAS), but they have no private pensions.

- Mrs. H said she does not remember signing the Client Data Forms but confirms that the income and net worth information on them is reasonably accurate. Mrs. H said the fixed asset amount of $350,000 - $400,000 was what Mr. C estimated as the market value of the home she and her husband purchased and renovated for $75,000 in 1991. All of their savings were invested with CFC and their home was their only other asset.

Investment Knowledge and Experience

- The 2002, 2003 and 2005 Client Data Forms show Mr. and Mrs. H as having "Good" investment knowledge.
- In his letter to CFC of April 7, 2009, Mr. and Mrs. H's son said that Mr. H had little investment knowledge and Mrs. H had no investment knowledge.
- Mrs. H said they had no investments before meeting Mr. C. She said they always lived "hand to mouth" and they only had money to invest after they sold their home in 1991. She said they had no knowledge of how to look after their money and relied on Mr. C for advice. Mrs. H said that Mr. C explained investments using terms that she and her husband did not fully understand, but they trusted and relied on him to make investment decisions for them.
- Mr. C did not maintain client file notes and could not recall if Mr. and Mrs. H had any investment experience before investing with CFC. He said he recorded their investment knowledge as good starting in 2002 because they had held mutual funds with him since 1991.
- During our interview, Mrs. H acknowledged that she and her husband knew they invested in mutual funds that fluctuated in value, but they were unable to describe the various types of investment funds they held or how the risks differed for each. Mrs. H did not have an understanding of general investment concepts like the relationship between risk and return. She also did not understand and could not accurately define terms that she says Mr. C used, such as growth, volatility and standard deviation. Mrs. H says they completely relied on his advice and decisions.
- Based on the evidence, we find that Mr. and Mrs. H had little investment knowledge and we cannot accept the Client Data Forms as being accurate in this regard.

Investment Objectives and Risk Tolerance

- The Client Data Forms Mr. C prepared showed the following investment objective and risk tolerance information:

Table 2: Investment objective and risk information on Client Data Forms

	December 2002	November 2003	April 2005
Investment Objectives	Debt 25% Growth 75-100%	Debt 25% Growth 75-100%	Debt 25% Growth 75-100%
Volatility	n/a	13 to 18	13 to 18
StdDev	n/a	Average	Average

- Each of these Client Data Forms was a one-page document that Mr. and Mrs. H signed at the bottom. The information was pre-printed on each form.

- The Client Data Forms refer to investment objectives of 25% Debt and 75% Growth. We have 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 investment objective categories used by most MFDA firms.

- Mr. C said that “Debt” on the Client Data Form “refers to something with more lower (sic) volatility, almost like a yield”. 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 Mr. and Mrs. H’s Client Data Forms, their “Std Dev” was recorded as “average” and their “Volatility” was recorded as “13 to 18”. We do not know of any investment firm that use 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 clients 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 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 Mr. and Mrs. H’s Client Data Forms indicated a medium risk tolerance.

- Mr. C explained Mr. and Mrs. H’s investment options as a choice between growth and lower volatility investments, 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 Mr. and Mrs. H.

- In addition to using terms that Mr. and Mrs. H did not understand, the fact that no other options were listed on the form meant that Mr. and Mrs. H would not have known what risk they were accepting relative to their other options. As Mr. C suggests, not having a relative measure on the forms renders the terminology meaningless.

- Mr. C does not have any notes from his meetings with Mr. and Mrs. H and could not recall details of his KYC discussions with them. While the Client Data Forms that Mr. C prepared suggest Mr. and Mrs. H were medium-risk investors with 25% income and 75% growth objectives, Mr. and Mrs. H had little investment knowledge and did not understand the terminology on the forms. For these reasons, we do not find the Client Data Forms are a reliable indication of Mr. and Mrs. H's investment objectives or risk tolerance.

- Mrs. H said that they were relying on their investments to provide them with income during retirement when they needed it. It is reasonable that this was their investment objective given that Mr. and Mrs. H did not have private pensions and that their only other source of income after they fully retired was their CPP and OAS payments.

- Mrs. H said that they did not want to take any risks with their investments. She says they knew their investments fluctuated in value, but given Mr. C's explanations of "growth" and "lower volatility", they thought they were appropriately invested and would not lose money. Given their personal and financial circumstances, they certainly could not afford to take a significant amount of risk with their investments.

Conclusion

Mr. and Mrs. H had little investment knowledge and completely relied on Mr. C for investment advice. They needed their investments to provide them with income and given their personal and financial circumstances they could not take significant risks with their investments. Mrs. H said they could not take any risks with their investments and while it may have been reasonable for them to only purchase investments with little or no risk, it also would have been reasonable, and arguably prudent, for Mr. and Mrs. H to have taken at least some risk with their investments. We believe that if Mr. C had advised them appropriately and explained, in terms they could understand, the risks and reasons why taking virtually no risk may have been a risk in itself, we believe Mr. and Mrs. H could have understood and agreed to take some risk with their investments.

Issue 2 – Were Mr. and Mrs. H's investments suitable?

- We conducted a detailed analysis of the investments in Mr. and Mrs. H's accounts. Although incomplete, based on the mutual fund company transaction information we have for 1991 to 2002, Mr. and Mrs. H initially held a mix of bond, balanced, and equity mutual funds that ranged from low to high risk. Over time, the bond component decreased and the equity component increased such that by 2002, there were no bond funds remaining. In addition, the allocation to low and medium-risk funds steadily decreased while the allocation to medium-high and high-risk funds increased.

- We believe we have complete mutual fund company statements for 2002 to 2009. Our analysis shows that at annual intervals from December 2002 to December 2008 (shortly before Mr. and Mrs. H began transferring away from CFC in April 2009) they were invested on average 94% in equity investments, including medium-high and high-risk equity mutual funds and several high-risk hedge funds. On average, 85% of their portfolio was medium-high and high-risk, while 10% was medium and the remaining 5% was in low-risk cash.

- Overall, we find Mr. and Mrs. H investments were unsuitable for them. The investment funds they held exposed them to a significant amount of risk and were not designed to provide them with them with income when they needed it.

- Mr. C said that all the investments he recommended to Mr. and Mrs. H were intended to reduce volatility or for growth and that all the investments fell within the equity standard deviation on their Client Data Forms. In other words, he assessed all of Mr. and Mrs. H's investments as being medium-risk or less.

- Mr. C said he recommended the Alternative Strategies Fund to provide clients with a "superior risk adjusted return" and "something that would give good downside protection". In his letter to Mr. and Mrs. H on January 12, 2010, Mr. C said that the standard deviation of the Alternative Strategies Fund was between 3.7 and 4.0, which was approximately equal to a portfolio of government bonds. During our interview on March 15, 2010, Mr. C said 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 Mr. and Mrs. H's investments.

- 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 is one indicator of risk, but it has its limitations and should be considered along with other factors. Mr. C was unable to provide us with any evidence that he actually determined the standard deviations for the investment funds he recommended. Standard deviation is based on historic performance and is not relevant for funds with a track record of less than three years. Given that some of the investment funds Mr. C recommended had only been created a year or two before Mr. and Mrs. H purchased them, including the Alternative Strategies Fund, it would have been impossible for Mr. C to have determined the standard deviation for those funds.

- Mrs. H acknowledges knowing that their investment values fluctuated. She says whenever they questioned Mr. C about it, he assured them they were invested for "low volatility," which given her limited investment knowledge she understood to mean their investments were appropriate. However, our analysis shows that Mr. C significantly underestimated the risk of the investments he recommended to Mr. and Mrs. H and he did not consult the primary disclosure document for these investments. Therefore, he could not have accurately disclosed or explained the risks to Mr. and Mrs. H.

Conclusion

Many of the mutual funds that Mr. C recommended to Mr. and Mrs. H were medium-high and high-risk equity mutual funds and high-risk hedge funds. In addition, Mr. and Mrs. H's initial allocation to cash and bond funds steadily decreased so that by 2002, they had virtually no fixed income investments. Therefore, we find the investments Mr. C recommended were not suited to Mr. and Mrs. H's investment objectives or risk tolerance.

Mr. C did not understand the risks associated with the investment funds he recommended to Mr. and Mrs. H and he could not have properly disclosed the risks to them. Since Mr. and Mrs. H had little investment knowledge and relied on Mr. C's advice, they did not understand and could not have independently determined that their investments were increasingly unsuitable.

Issue 3 – If their investments were unsuitable, did Mr. and Mrs. H suffer financial harm as a result?

- While it is clear that Mr. and Mrs. H lost money on their investments, it was challenging in this case to determine their financial harm because the data we have for their investments is incomplete. For example, Mr. and Mrs. H say they initially invested $300,000 with Mr. C and while that seems to make sense based on the information we have, we have been unable to verify it. Also, while we believe we have accurate information for Mr. and Mrs. H's portfolio from 2002 onward, we do not have complete information about how they were invested with Mr. C for the first few years.

- Based on the mutual fund company transaction histories and account statements we have collected, we calculate that from 1991 to 2009 Mr. and Mrs. H lost $87,338 on their unsuitable medium-high and high-risk investments alone. If the money they invested in medium-high and high-risk investments had instead been used to purchase lower-risk income investments, they would have initially had a mix of lower-risk income and medium-risk equity investments with an emphasis on lower-risk. Over time, the percentage of lower-risk income investments in their portfolio would have increased and from 2002, when they were 72 and 62 years old respectively and fully retired, their portfolio would have been almost completely invested in low-risk income investments. We believe this would have been suitable for Mr. and Mrs. H given their investment objectives, risk tolerance and personal and financial circumstances.

- Given Mrs. H's stated preference for no risk, it would have been appropriate for the Mr. and Mrs. H's lower-risk investments to have been a mix of 1-, 3-, and 5-year GICs. If that had been the case, we calculate that Mr. and Mrs. H would have earned $98,178 by April 2009 when they transferred away from CFC instead of losing $87,338. Taking this approach we calculate Mr. and Mrs. H's financial harm to be $185,516 ($87,338 + $98,178).

Conclusion

Instead of purchasing the medium-high and high-risk investment funds, Mr. and Mrs. H should have invested that money in low-risk income investments. Given Mrs. H's stated preference for no risk, we are recommending compensation of $185,156 based on the returns they would have received if they had simply invested the lower-risk income portion of their portfolio in GICs.

Issue 4 – Who should bear responsibility for Mr. and Mrs. H's losses?

- In this case, Mr. C allowed Mr. and Mrs. H's accounts to be unsuitably invested contrary even to the inaccurate KYC information

- From Mr. and Mrs. H's perspective, they believed that Mr. C had made investment recommendations that were suitable for their needs and circumstances. They had little investment knowledge and completely relied on Mr. C's advice.

- 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. and Mrs. H did not realize their investments were unsuitable and when they did raise concerns about the fluctuating value of their investments, Mr. C indicated their investments were appropriate.

- 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 Mr. and Mrs. H's investments were suitable for them.

- It does not appear to us that there is any basis to impose responsibility on Mr. and Mrs. H, because they did not act negligently. It would be unfair to apportion responsibility to them for the financial harm arising from Mr. C's unsuitable recommendations.

Recommendation

For the reasons outlined above, we recommend that CFC compensate Mr. and Mrs. H $185,516 plus $5,167[1] in interest for a total of $190,683.

[1] Interest is calculated using the average 3-month Canadian Treasury Bill yield of **0.91**% (as calculated by the Bank of Canada) compounded annually to the date OBSI's report is final.