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## Are advisors to blame for Portus?

Outgoing OSC head slams advisors

On May 10, 2005 Ontario Securities Commissions Chairman David Brown delivered a speech to the Toronto CFA Society. In what may be his last speech as the head of Canada's largest securities regulator, Brown makes assumptions about advisors' motivation for recommending Portus' hedge fund product and the standards by which they're bound when making such recommendations.

### That's a stretch

Brown was really making a case for regulatory change and the need for a national securities regulator in Canada. This is something that the both the Toronto CFA Society and the related Charlottesville, Virginia-based CFA Institute strongly and publicly endorse. In my opinion, however, Brown misfires by holding out Portus' recent fiasco and blaming commission-hungry advisors for referring some $750 million to the now defunct company.

Brown's held out the standards to which all CFA charterholders are bound – and uses them to explain where advisors went wrong. With respect to assigning 'blame' in the Portus fiasco, Brown further stated that,

> "There may well be some issues to address in relation to the manufacturers of some of these investment products. But the responsibilities of the intermediaries involved are clear. They are professionals with a duty to understand the products involved and the risks entailed."

Specifically, here is where his reasoning breaks down, in my opinion.

First, he calls referring advisors "professionals". While many advisors would like to think of themselves as professionals, the fact remains that the vast majority of licensed advisors actually carry a license to sell, not to advise. The credentials and educational requirements to obtain such a license is minimal – a single licensing course in many cases

that barely scratches the surface of what advisors really need to know. (IDA brokers must meet more stringent proficiency requirements.)

Fortunately, many advisors conduct themselves professionally and take it upon themselves to further their knowledge base by taking continuing education courses and obtaining financial designations. But this is not required by regulators who are responsible for the prevailing system. Brown is expecting licensed salespeople to live up to the standards of professionals when no clear standards exist for such advisors.

Second, Brown holds out the CFA Institute's Code of Ethics and Standards of Professional Conduct as the example for licensed salespeople – most of whom don't hold this designation. I don't disagree with the Code. I am a CFA charterholder and pride myself on the minimum standards to which I am bound. But if he wants this as a minimum standard, he should make it a condition of licensing and toughen the proficiency requirements. Yet, neither the OSC (nor any regulator) has done so for the basic sales license held by the majority of 'advisors'.

These issues aside, it's worth asking if individual advisors bear some responsibility for what has transpired. My answer is yes, that they should accept some, but not all of the blame.

**True motivations**

Brown said the following of Portus' sales success:

> "So what could have accounted for the firm's tremendous sales record?
>
> Perhaps there is only one particular feature to speak of – high up front fees and trailer fees for referrals. The potential earnings for agents were high."

While compensation was surely a motivator for some advisors, Brown completely misses what I think is an equally (and perhaps more) powerful motivator. To my knowledge, Portus was promoted as a low-volatility investment option with strong return potential that was backed by the guarantees of a big European bank.

Coming out of a bear market, advisors were tired of having to explain why their clients' most recent statements were lower than the previous one. So, sure Portus offered more lucrative compensation compared to other products. But, more importantly, it offered the

lure of something even rarer at that time – an investment with big potential but low risk if held to maturity.

**The blame game**

Advisors obviously rely to varying degrees on their dealers when it comes to vetting investment products for compliance concerns. It is not necessarily a dealer's job to assess a product's investment merit but rather to clear it from a compliance standpoint. Since dealers have to designate someone as a compliance officer, it stands to reason that such individuals are qualified to vet even complex products. Two big warning signs should have signalled real concerns based on the September 1, 2004 offering memorandum for Portus BancNote Trust Series X (F and I class units).

First, products sold by offering memorandum are subject to the accredited investor rules, which state that the product may only be sold to investors meeting specific net worth or income tests. While the minimum investment highlighted in the OM is $250k, I found no mention of this rule or any related acknowledgement that such clients are usually required to sign (to confirm their accredited investor status). Interestingly, the quoted figures for Portus – $750 million invested by 26,000 investors – points to an average investment of $28,846.

Second, no banking institution was named as the guarantor of the notes to be purchased by the trust. Also, the language of the guarantee was such that there was no real obligation to provide notes with a guarantee. See my previous article for some details on this issue.

That said, advisors must share the blame because they ultimately are responsible – at the very least – for recommending clients buy specific products. Advisors must further ensure that the product is suitable for the client in question, based on individual circumstances and the specific aspects of recommended products.

**Regulatory arbitrage**

Perhaps something that should be considered by Mr. Brown and the OSC is that the regulatory environment has encouraged the financial engineering of more complex products to get around accredited investor rules to gain access to the retail market.

Ironically, the structures that allow such sophisticated products to penetrate the retail market are more complex than the products from which regulators are protecting small investors. (Note: Portus was not a linked note structure.) These more complex structures – like linked notes – actually cost investors more money and are more difficult to understand.

That doesn't exactly sound like the 'investor protection' mandate that the OSC trumpets so loudly.

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