

Presentation to the Expert Panel on Securities Regulation

by

The Consumers Council of Canada

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The Consumers Council of Canada is a federally incorporated, independent, not for profit organization that was established to give a voice to consumers and to help business and government manage consumer issues. Our goal is to work collaboratively with consumers, business and government to solve marketplace problems..

Our members, both individual and corporate, acknowledge and support the eight international consumer rights to basic needs, safety, information, choice, representation, redress, consumer education and a healthy environment. To these, the Council has added the right to privacy. We encourage organizations to partner with the Council in addressing consumer issues. It is good business to manage these issues effectively

Consumers Council of Canada
1910 Yonge St, 4th Floor
Toronto, Ontario
M4S1Z5
Ph. (416) 483-2696
Fax (416) 483-4128)
www.consumerscouncil.com

Presented by:
Whipple Steinkrauss
Chair
Finance Committee
(416) 225-6872
whip@rogers.com

Mr. Chairman and fellow panel members, thank you for giving the Consumers Council of Canada the opportunity to comment on this review of securities regulation. About five years ago, it became apparent to our Council that there were many consumer (retail investor) issues with respect to this industry that were not being adequately addressed and that the current regulatory regime no longer serves Canadians as well as it should. Let me say at the outset, there are many good things about this industry but in the few moments I have today, I want to focus on what we think needs to be fixed and why.

Background

The gradual disappearance of defined benefit and other types of corporate pension plans, the increasing globalization of the capital markets. The growing complexity of financial products sold to retail investors, the aging and increasing longevity of our population, and the long period of unusually low interest rates have all contributed to the many problems and issues that have come to the Council's attention.

There are huge numbers of new retail investors in the securities marketplace who may not even be there by choice. Regrettably few of these investors have been adequately prepared for this role. As you know, with few notable exceptions, our public education system has never included the teaching of financial skills and literacy in the curriculum. Even if we begin to do so now, it will take a generation to correct this tragic situation. There are two very vulnerable groups, aging seniors and young workers. A very large portion of these groups tends to rely on the front line of industry for financial advice and on government for some measure of protection from undue risk. While, no credible consumer organization believes that investors can or should be shielded from all risk, as a society, we do have a responsibility to ensure they are given the tools they need to make informed decisions and protection when they pay for professional services that are found wanting. This is the Council's primary concern.

The Council can cite countless situations where capital-rich seniors covered by virtually bullet-proof wrap agreements have lost almost all of their retirement savings and have no recourse to redress, others who have had the bulk of their retirement accounts placed in DSC (Deferred Service Charges) funds one or two years before they must wind up their RRSPs, and still others steered into high-fee, high risk-return investments that they do not understand. Among investors generally, the Council has been told of individuals forced into protracted lawsuits and other manoeuvres when there has been fraud in their accounts, churning of accounts with no benefit to the investor, investors who have never received a copy of their KYC (Know Your Client) form and others rated well above their level of competence in terms of financial sophistication leaving them in a very weak position for any hope of redress should an issue of product suitability arise. The few who get redress for some industry failing are usually silenced by confidentiality clauses leaving others to be victims of the sorts of practices they experienced., sometimes by the same perpetrators.

While the Council knows that the majority of men and women in this industry are decent people trying to do the best for their clients, the regulatory challenge is to weed out and punish miscreants and incompetents without placing the entire industry in a straight jacket that does little to solve the issues at hand and undermines Canada's position in the capital markets. Good regulation always benefits good business. What is needed is not more regulation but better regulation.

The ABCP (Asset-Backed Commercial Paper) issue and the ensuing Crawford Report have greatly radicalized the investor advocate community in that it exposed regulatory inadequacy and negligence, the unbridled greed of some in the industry, the incompetence and/or negligence of rating agencies, the lack of clear accountabilities for harm to investors and/or the capital markets, the clear bias to protect industry insiders and the capital markets at the expense of the small investor, and the failure to adequately address the challenges of globalization of the industry, to name the most significant. It is the perfect backdrop for the work of this committee.

1.Objectives, Outcomes and Performance Measures

The Council strongly supports the notion that securities regulation needs clear objectives, outcomes and performance measures. However, there are, in our view, some glaring shortcomings in the current proposed objectives and indicators. First, the industry should strive to achieve a level of transparency that informs the general public as to how the markets work. Second, as an objective, the industry should ensure not help investors receive a fair deal. The latter suggests that fairness is negotiable. Third, there is no better issue than the ABCP crisis to expose the weakness of excluding the reduction of systemic risk as a key objective. A case study of this crisis detailing the shortcomings of all parties to the transactions would inform the public of what changes are needed and why. Further each party to securities transactions should have some exclusive responsibilities and sufficient financial reserves for redress should they fail in those responsibilities. It is not surprising that industry balks at the right to sue given today's shotgun approach of suing every party to a transaction. In this matter, protracted disputes over shared liability should be settled internally to the industry not at the expense of the retail investor. In my personal experience as a regulator, industries that are required to cover the costs of their own regulation and any redress required take a far greater responsibility for not only the conduct of their own firms but also of the industry as a whole. I am sure most of you will recall how quickly the Law Society of Upper Canada began to clean up problems in that profession when professional fees skyrocketed some years ago. If and when clear objectives and performance measures are adopted, these need to be widely disseminated in plain language to enhance financial literacy. Finally, quite apart from overall industry performance measures, there is a critical need for publicly set performance standards around complaint handling and redress that include timelines

2. Principles-Based Securities Regulation

Given the velocity of change in the marketplace today, it is essential that securities regulation be under the umbrella of overarching principles that inform the interpretation of the rules. Clearly, there are many instances where specific rules may be necessary and it appears rules-based approaches are more often preferred by industry. Nonetheless, this approach is far too static to address emerging issues and opens up opportunities for those with access to superior legal talent and deep pockets to prevail in situations that are not in the best interests of investors, the public and/or the capital markets. Not so long ago, the Insurance Bureau of Canada adopted a guideline for insurances brokers and salespersons that requires that priority be given to the interests of the client when they collide with those of the industry participant. Such an overarching principle in the securities industry

would have prevented the very powerful public backlash to the Crawford Report and the ensuing loss of public confidence in our capital markets. The cost of investor redress in this instance has proven to be a very tiny part of the overall estimated cost of addressing this crisis yet investors were ignored until there was a huge public outcry. Given the scale and range of participants involved in this crisis, it may have been necessary to make some rather unseemly compromises to reach agreement on how to deal with it, but it is quite apparent that investors will not willingly accept exempting them from litigation. If we are to be in the global marketplace, it is time for changes to international standards for this industry. This committee should propose whatever changes are needed to ensure that going forward industry participants are neither found liable for no fault nor exempt from litigation when they fail in their responsibilities.

A key principle should be a clear separation of authority with regard to the adjudication of disputes with investors. Either via professional or licensing fees, the industry should fund redress but not control it. Given the disparity between the resources of individuals and large corporate entities, an industry-controlled system is unlikely to be fair or balanced in its decision-making. There is a need for a low-cost redress body with the authority to enforce its decisions. The court system is far too costly and drawn out to serve all but the minority of investors with considerable resources. The Council is aware of far too many cases where the redress process has taken so long it has resulted in financial ruin, ill health or worse even when the issue of fault has not been in question. In one case a middle-aged couple lost their entire retirement account through the fraud of their broker. Despite a criminal conviction, the couple fought for four years to get their money back. This had an appalling impact on the family. We are aware of others where litigation has taken up to ten years. In the case of seniors, this often leaves them penniless. In a few cases, clients have not lived long enough to get a settlement. To avoid liability and legal precedent, miscreants in the industry will often drag out legal proceedings to exhaust the complainant financially and emotionally. Admittedly these cases as a percentage of all transactions are very small but when they arise, their impact is devastating on the investor.

Whether by a revamping of OBSI (Ombudsman for Banking Services and Investments) or a new body, redress should be governed by a board with half of the representatives from industry, half from the public and a neutral chair. Public representatives should not have, or should not have had for a number of years, any financial relationships with the industry beyond their personal investments.. There are many individuals with experience in regulation, consumer policy, academia, the law and the small business community who could capably fulfil this role. Each group could be permitted to choose one institutional investor to accommodate such bodies as pension funds and mutual fund dealers. The Motor Vehicle Dealers Compensation Fund in Ontario is a good model. In Ontario at least, we have often said consumers are better protected when they buy a car from a licensed dealer than when they buy securities.

Another overarching principle should be the elimination of conflicts of interest in the industry. For example, rating agencies should not be compensated directly by the industry but rather by professional or licensing fees contributed to a public authority. Further, both these agencies and all regulatory authorities should have very strict limitations on whom they can employ to ensure they are not in the pocket of issuers or industry insiders. In general, firewalls between the various players in the industry along with clearer

accountabilities would reduce the perverse incentives that characterize the industry today. A second issue that is more difficult to tackle are compensation practices in the industry that are not aligned with investor interests. Some measures to restrict opportunities for profiteering should be in place. The Council will leave this issue to others to address but would like it addressed by this Panel. Requiring bonuses to be based on measurable results achieved over a longer time frame and the cancellation of options, severances and the like when firms go bankrupt might be explored. When senior executives walk away with millions of dollars and investors and rank and file employees are left with nothing, we truly are in the “wild west”.

3. Proportionate Securities Regulation

While the arguments presented for proportionate securities regulation are persuasive, size and resources along with the risk to the capital markets are insufficient grounds for bifurcated regulation. Another important factor is what products are being sold. Canada does not need another “we didn’t know” case. If the system is to be proportionate, it seems reasonable that there might be some limitations on what the lesser regulated can sell. From an investor point of view, more problems arise when firms sell hedge funds, and other structured products than when they deal in individual securities. If risk analysis adequately addresses risk for the individual investor, there may be some justification for two levels of regulation.

4. Enforcement

As indicated earlier, the Council supports overarching principles that guide the industry and inform the interpretation of rules. We also support the separation of the adjudicative function not only for redress but also with respect to business conduct. Rightly or wrongly, it is our overall impression that big earners for firms are often given a pass when guilty of misconduct. We believe such issues as the overall staffing of regulators and the de facto delegation of authority to those with no or inadequate legal accountability contribute to this problem.

In looking at enforcement, it is critical that the instruments used be effective. Why give authority to impose fines without the authority to collect them? If not collected what harsher measures are available to the regulator? Being forced to leave the industry with millions of dollars in hand can hardly be described as a deterrent or a punishment. If enforcement is controlled by industry, what independent appeal process is in place for those who believe they have been treated unfairly? Finally, some requirement to take action when a number of complaints are received should be legislated. Further, where the seriousness of a complaint or a number of complaints are well-founded, the industry should be required to publish the name of the miscreant. About a year ago, an aggressive investor advocate gained access to the IDA complaints file and learned of individuals working in the industry with as many as 50 complaints on file against them yet no investigation had been undertaken nor sanctions imposed. This file was widely circulated on the net. In the electronic age, such information can be distributed world wide in a matter of minutes and can greatly harm Canada’s reputation as a good place to invest. The Council often receives information from industry insiders who feel they are working at a disadvantage because such individuals go unpunished. Many claim if they speak up,

they are penalized. As you know, the best salespersons are the best compensated not necessarily those who produce the best results for their clients

5. Securities Regulatory Structure

It is the Council's view that the securities regulatory structure in Canada undermines our competitiveness in the industry, adversely affects enforcement and therefore increases both the risks and costs to individual investors. Were it not for the overall quality of our banking system and our abundance of natural resources, one wonders whether we would attract any issuers from beyond our shores. Even our banking system is declining in influence as consolidation around the world has moved us out of the top tier. While the Council believes a single national regulator would be preferable to the balkanized system we now have, if other issues are not addressed, it will not solve many of the challenges we face. At minimum, we should have common standards across the country with each jurisdiction recognizing the decisions of others.

It would be instructive to publish the five principle reasons why each jurisdiction feels it cannot reach a compromise on this issue and survey the public for their views. At minimum, this might create the necessary public momentum to drive change. This balkanization is undoubtedly our worst inter-provincial trade barrier. It is costly, inefficient and makes us increasingly irrelevant in the global capital markets.

Canadian investors pay among the highest fees in the world for securities transactions. It is important to identify for the public the savings that could be achieved by consolidating securities commissions. The Council is looking for inspired leadership to resolve this issue now. We have had more than enough studies and should not be wasting scarce public (taxpayers') dollars to reinvent the wheel. Studies primarily are read by the same few people with hard-line positions as to which model is best. A new more political approach is needed to resolve this problem.

In closing, there is one issue the Council wishes to raise. From time to time, investor representatives are invited to participate in consultations such as this or serve on advisory groups. We find ourselves surrounded by highly paid individuals who have an abundance of resources at their disposal to develop positions that reflect their interests. Investors have none. With no core-funded body to conduct the type of research that would make that participation meaningful, we become mere window-dressing. For example some four years ago, I believe about 20 investor advocates appeared before the Ontario Committee on Finance and Economic Affairs. These presentations were written, typed and presented by volunteers. To date, we have received no feedback on our submissions. Even worse, to my knowledge, there has been no follow up on the many recommendations that were made. England has given investors considerably more clout by creating a core funded Financial Services Consumer Panel with resources to do research and the authority to review key decisions in the industry. Such a panel in Canada would help to redress the power imbalance between the individual investor and major corporations. Given the appropriate authority, it would provide an ongoing consumer voice in the industry. Our Council urges this Panel to look at this model for possible adoption in Canada. Given the size and dollar value of this industry, the relative cost of doing so would be miniscule. I thank you again for your time and attention

