

February 25, 2008

Honourable James M. Flaherty
Department of Finance Canada
140 O'Conner St.
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Re: Canadian Securities Reserve: A Framework for Restitution

Dear Mr. Minister:

I'm writing today to propose a system of national reserves for the securities industry in Canada. As you may know, the investment industry in Canada does not have a system of financial reserves, unlike its counterparts in commercial banking and insurance. This is a great pity and a profound industry oversight, as it largely explains (from my perspective of 20 years in investor protection) the unusual amount of systemic risk in the industry.

Given the tremendous growth in the capital markets in recent years and the long-standing desire for a common securities regulator in Canada, the need to modernize our capital markets has never been greater. Accordingly, last week, your department announced the formation of a panel of experts and special advisors to provide "advice and recommendations on securities regulation in Canada." I would like to encourage the panel to include discussion of a national reserve system for securities in its deliberations.

Overview

A securities reserve is a financial deposit set aside by a securities market participant for the purpose of providing investor protection. It is created when a securities dealer agrees to deposit a percentage (~10%) of the proceeds from an offering into a trust created to protect subscribers against conduct by an issuer that is found to be prejudicial to the interest of investors.

With each successive offering, the amount of funds in a firm's reserve account will increase. In time, these funds will exceed the value of a single distribution and provide investors with a significant source of funding for restitution.

Currently, no significant source of funding exists to provide investors with financial restitution in Canada. Risk-adjusted capital, investor protection funds, professional insurance, civil and criminal remedies are mechanisms to protect investors, but these remedies have proven inadequate to address financial harm suffered by investors. Recent high profile securities proceedings have demonstrated the sad lack of adequate financial protection for investors in the Canadian securities industry.

An independent authority will need to be formed to administer trust funds, provide a process for investor restitution and ensure effective regulation of market participants.

Proposed Structure

The best candidate in Canada to establish a system of national reserves is a common securities regulator. It will have the advantages of national scale and scope, with the ability to appeal internationally for investment capital and reserve participation. As well, it will provide a single, modern system of regulation for the securities industry in Canada.

Once registered with the common securities regulator, participating firms will be required to deposit a percentage of the proceeds from a distribution into the national reserve system and adhere to the regulatory framework of the common securities regulator.

In addition, participating firms should agree to publish the value of their national reserves in annual financial statements and should be required to adjust reserve balances periodically to reflect changes in business, underwriting and issuing conditions. The national reserve system should also serve a protection for investors abused by financial professionals employed by participating securities dealers.

Equity capital carries the greatest risk for investor abuse and is, therefore, the most suitable form of capital for reserve protection, though other forms of risk capital may be suitable. It is not expected that the common securities regulator will participate in securities trading. Initial offering and secondary trading of equity securities is best conducted through the facilities of a recognized stock exchange, electronic market or private transaction.

Reserve Period

A number of factors will be considered when determining the length of time funds should be held in the national reserve system. These factors include the size and nature of the distribution, the nature and number of associated distributions issued by the participating dealer, the business composition of a participating dealer and its regulatory record.

To adequately protect the interest of investors, the minimum length of time that funds should be held in the national reserve system is five years. At the close of the reserve period, the right of an investor to appeal for restitution will end, and funds held in the reserve system will be returned to a participating dealer for distribution to the issuing organization or to investors. A portion of interest earned on funds in the national reserve system will be used to finance the activities of the national regulator.

Modern Investor Protection

The main purpose of a national reserve system for securities is to protect investors from fraud, misrepresentation and misappropriation. The reserve system will not insulate investors from market or business risk. It will be used to protect investors against defective investment product, unacceptable distribution risk and conduct by an issuing organization that in opinion of the common regulator is prejudicial to investors.

The common securities regulator will have full discretion over the restitution of reserve funds. A process to apply for restitution should be developed shortly after formation of the national reserve system. An insolvent firm or a firm failing to maintain adequate

reserves should have its access to the reserve system restricted and restitution of reserve balances initiated, until minimum capital reserves are restored.

Efficient Capital Formation

In exchange for participation in the national reserve system, a participating dealer will receive swift and unencumbered access to the Canadian capital markets. The legal protections contained in the securities registration process will be replaced by a robust system of financial disclosures and reserve protections. Speed to market for participating dealers and issuers will improve as the requirement in the securities registration process for legal disclosure and prospectus receipt will be replaced by the practical financial protections of a national reserve system.

Participating dealers wishing to distribute securities with reserve protection in Canada will be required to complete the necessary filing notice, post the minimum reserve requirement and ensure an issuing organization maintains appropriate corporate and financial disclosure during the reserve period.

Effective Oversight

The national reserve system will provide securities administrators with significant financial leverage to control high-risk industry behaviour. As regulators in banking and insurance have learned over the years, rate and reserve setting authority has proven to be an effective tool to reduce product concentration risk, control distribution of complex or exotic product structures and remedy aggressive industry behaviour. Influence over the level of industry activity has proven to be an elegant and effective risk management tool for financial services administrators and is the best argument for adopting a reserve system for the securities industry.

Participation

Participation in the national reserve system will be offered on a voluntary basis to securities dealers and underwriters. Participating securities dealers will be required to maintain registration in 'good standing' with the national regulator, including compliance with the regulatory framework of the common regulator. Foreign dealers wishing to distribute securities in Canada with reserve protection will be required to register with the national regulator, maintain a physical address in Canada and agree to follow the national regulatory framework.

Leading Capital Markets

A national reserve system for securities will result in a unique 'made in Canada' solution for our capital markets and will be the first reserve-based system for issuing investment capital in the world. With quick action by the expert panel (and the Department of Finance) to protect the business system, patent interest and commercial value contained in a national reserve system for securities, a modern, efficient and sophisticated capital market with a durable competitive advantage in global finance will emerge for Canadians.

An Idea Whose Time Has Come

Last summer, I proposed a similar reserve system in discussions with representatives of the International Centre for Financial Regulation, the Financial Services Authority and the London School of Economics at the London offices of Mervyn Davies, Chairman of Standard Chartered Bank. Considerable interest in a reserve system for securities was expressed at that time.

I would like to thank you for the opportunity to discuss my proposal for a national reserve system for securities in Canada. I wish the expert panel providing “advice and recommendations on securities regulation in Canada” much success in its work. I’d be happy to discuss the proposal with the panel, its special advisors or staff at a time convenient for those involved. Thank you again for your interest.

Sincerely,

Michael F. Rhodes, MBA
White Rock, British Columbia

cc: Doug Hyndman, Chief Executive Officer, B.C. Securities Commission
William S. Rice, Chief Executive Officer, Alberta Securities Commission
David Wilson, Chief Executive Officer, Ontario Securities Commission
Jean St-Gelais, Chief Executive Officer, Autorité des marchés financiers