A Voice for the Small Investor

SIPA Inc

Submission to

Joint Forum of Financial Market Regulators

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Comments and Recommendations

for consideration in the development of

Joint Forum 2005 – 2008 Strategic Plan

January 17th, 2005

A Voice for the Small Investor

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Mr. David Wild
Chair, Joint Forum of Market Regulators
5160 Yonge Street, Box 85, 17th Floor
North York, ON, M2N 6L9

Dear Mr. Wild,

SIPA was founded in 1998 because there was no authority with a prime responsibility for investor protection. Later that same year Glorianne Stromberg released her report "Investment Funds in Canada and Consumer Protection." The comments in her report could be extrapolated to apply to the investment industry generally.

On December 17th, 2003, the Wise Persons Committee issued a report "IT'S TIME". The Minister of Finance gave the WPC chaired by Michael E. J. Phelps, a mandate to review the structure of securities regulation in Canada. These Wise Persons concluded that Canada needs a national regulator.

The small investors' problems will not be resolved by a change in regulatory jurisdictions. Whether the regulatory regime remains unchanged, or becomes integrated as a national regulator, small investors will remain at risk until an Authority with a mandate for investor protection is established.

As "A Voice for the Small Investor" SIPA is pleased to offer our comments and recommendations for your consideration as you formulate your Strategic Plan.

We have every confidence that Canadians generally want to behave in a moral and ethical fashion. The outpouring of sympathy for the victims of the Tsunami and the monetary contributions for relief work illustrate the good nature of Canadians generally.

It is the responsibility of Government, Regulators and Police to enable all Canadians to live and work in a society that does not foster wrongdoing. We trust that the Joint Forum will make every effort to ensure Canadians may be secure in their investments.

Sincerely

Stan I. Buell
President

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1. Forward

The Joint Forum of Financial Market Regulators has invited input on what the Joint Forum's strategic priorities should be over the next three years. The Joint Forum asked stakeholders to identify gaps and overlaps in the financial services regulatory system and to propose ways to improve regulation across the pensions, insurance and securities sectors across Canada.

The Small Investor Protection Association was founded because it appeared there was no authority responsible for investor protection in a meaningful way. We found that most Canadians did not understand the fractured regulatory approach for the investment industry. It was determined that securities regulation is a provincial jurisdiction, and securities administrators had delegated investor protection to the Investment Dealers Association (IDA), a self-regulatory organization representing its members' interests. It seemed a conflict of interest and investors did not have a fair chance.

Since 1998, SIPA has communicated with hundreds of small investors as well as industry participants, regulators and government. Our conclusion is that either the leaders of the investment industry and of our country are not aware of the impact on ordinary Canadians of the widespread wrongdoing in the industry that often result in the destruction of life savings of small investors, or the fabric of our Canadian society is not as homogenous as one would like to believe.

The Wise Persons Committee Report, released December 13, 2003 in its opening statement of the Executive Summary states:

> *"Canada suffers from inadequate enforcement and inconsistent investor protection. Policy development is characterized by compromise and delay. Canada cannot respond as effectively or innovate as quickly as it should in the fast-changing global marketplace. The system is too costly, duplicative and inefficient. The regulatory burden impedes capital formation. Canada's international competitiveness is undermined by regulatory complexity."*

To make Canada's leaders aware of the problem of small investors losing their life savings due to industry wrongdoing, SIPA prepared a report and delivered it to leaders across Canada in February 2004. The report is entitled "SIPA Inc Five Year Review ~ the Small Investors' Perspective of Investor Protection in Canada". The report contains anecdotal information supported by fact, and quotes individual investors.

Also in 2004, SIPA associated with CARP, Canada's association for the 50 Plus, to prepare a report on the mutual fund industry entitled "Giving Small Investors a Fair Chance".

A copy of each of these reports is appended to form part of this submission.

2. Our Society is based on Trust

Our society is based on trust and values. There is a feeling that many in our society no longer have any sense of values and standards and that the investment industry in particular can no longer be trusted. There are issues that are becoming more serious as each day passes. There have been studies and reports precipitated no doubt because it is painfully apparent that something must be done to restore credibility and confidence in our investment industry and regulatory system.

Glorianne Stromberg stated in an article entitled "Listen up, Bay Street ":

> *"The lack of trust in Wall Street (and by extension Bay Street) is said to be unparalleled since the 1930s. Polls indicate that a growing number of people believe the stock market is no longer a fair and open way to invest one's money and that the market is rigged by and for insiders. A recent New York Times article bluntly stated that the hidden hands of speculators profiting from bad-news rumourmongering, good-news insidership, and no-news accounting has made markets unsafe for ordinary investors."*

A Business Week editorial on February 2, 2004 stated:

> *"The cockroach theory of financial scandals says that, for every one you see, hundreds more are hiding in the woodwork. ... Scandals break out in bunches because they have common causes. They occur when insiders take advantage of weak corporate governance, feeble government oversight, and a financial system that too often looks the other way."*

The editorial suggests that the destruction of trust is a serious consequence:

> *"There is obvious harm to these companies' shareholders and creditors, such as Parmalat bondholder AFLAC Inc. Less visible but more serious is the destruction of trust, which makes it harder for honest companies to raise the money they need to grow. Overseas, as in the U.S., the solutions are clear: Transparency. Accountability. Tough audits. And criminal penalties for those who cheat. Halfway measures are an invitation to more cheating."*

Arthur Levitt, the former chair of the U.S. Securities and Exchange Commission, refers to the failures that the corporate scandals have revealed as "societal."

> *"These failures reflect a deterioration of values and the recognition that many people have no standards or values, which is something we should all be gravely concerned about."*

David A. Brown, Q.C., Chair, Ontario Securities Commission, has also played a role in the Canadian Centre for Ethics & Corporate Policy as a member of the Board of Directors and later as Executive Director. In his remarks "Beyond Product Sales: Considerations Other than the Bottom Line" to the Centre, in Toronto on April 1, 1999, he stated:

> *"The basis of any ethical system is values; including the way individually and corporately we treat one another on a micro and macro scale, the manner in which*

we support the larger community and the care with which we preserve or restore this fragile planet, our home."

In her 2004 New Year's message Governor General Adrienne Clarkson said:

"The public good is expressed in the way we live ... we can look confidently towards the future in whatever we do if we know that we have anchored ourselves today in what is good and what is right. Let's make 2004 a year in which we all reflect on what we've done in the past. And go forward as Canadians with our values, our acceptance and our dreams."

The Auditor General Sheila Fraser is quoted by the press:

"Our findings on the government's sponsorship program from 1997 to 2001 are deeply disturbing. Rules were broken or ignored at every stage of the process for more than four years. Even though the government has cancelled the sponsorship program, I am deeply disturbed that such practices were allowed to happen in the first place. There has not been an adequate explanation for the collapse of controls and oversight mechanisms."

On June 15th 2002, the New York Times quoted Treasury Secretary Paul H. O'Neill from a speech on Thursday:

"I think people who abuse our trust, we ought to hang them from the very highest branch"

Ralph Goodale, Minister of Finance, wrote to SIPA on May 31, 2004;

"I share your view about the importance of investor protection. Indeed, one of the fundamental objectives of securities regulation is to protect investors from unfair practices. It is imperative that any reforms to our current system of securities regulation measure up to this objective."

It seems the vast majority of Canadians still believe in honesty and integrity. Why then do we tolerate the widespread wrongdoing, cover-up and fraud?

CEOs mislead the public, auditors verify reports containing inaccurate information, analysts provide reports that are less than truthful, and the investment industry leaders look the other way while seniors are losing their life savings due to deliberate wrongdoing.

It is time that our regulatory regime, government and police take action to restore Canadians' confidence in the investment industry. The Joint Forum must make such recommendations as are deemed necessary to help restore confidence in the investment industry before the damage is irreparable. Your recommendations should emphasize the need for improved investor protection.

3. Investor Protection

The Wise Persons Committee Report incorporates a statement submitted by Jarislowsky Fraser Limited of Montreal, Quebec:

> *"The greatest weakness of the regulatory system is that it does not protect investors.... There is ever more red tape and no real enforcement! The crooks rarely go to jail."*

In recent years the investment industry has developed products that are being sold by banks, insurance companies, mutual fund companies and investment dealers. These products, including mutual funds, segregated funds and pooled funds, are perceived as similar by small investors but are regulated by different agencies.

Financial predators take advantage of the lack of investor knowledge and the propensity of Canadians to trust. Seniors are particularly susceptible to smooth talking blue suits and fraudsters.

It is not unusual for financial perpetrators to leave a long trail of victims even after the regulators have identified them as fraudsters. Small investors have no means to protect themselves and are at risk due to the lack of co-ordination between regulators and police in different jurisdictions and their reluctance to reveal ongoing investigations.

SROs are unable to offer adequate investor protection due to their inherent conflict of interest. The regulators appear unable or unwilling to order restitution even when industry representatives are found guilty of wrongdoing, including breach of fiduciary duty and fraud. Indeed, in the case of fraud it is rare that criminal proceedings are initiated. Penalties that are assessed are insufficient to discourage industry participants from continuing rule-breaching practices and having a cavalier attitude towards the welfare of small investors.

Small investors need investor protection that is not industry sponsored. While some have suggested a federal regulator similar to the Securities and Exchange Commission in the United States would be appropriate, recent action by the New York State Attorney General Eliot Spitzer reveals even the S.E.C. has limitations.

Spitzer's great concern, he said, is the fundamental effectiveness of how Wall Street polices itself for the benefit of investors;

> *"The major failure has been at the SRO (self-regulatory organization) level," Spitzer told The Post.*

Studies, reviews and reports have for many years examined the regulatory system, recognized the problems and recommended solutions. The investment industry has been reluctant to change and has co-opted efforts to provide improved investor protection. Some

recent proposals appear to be contrary to investors' best interests. It is time for the joint forum to consider innovative approaches to regulation rather than simply adding another layer of regulation without ensuring enforcement capability and investor protection.

Glorianne Stromberg states in an article entitled "Listen up, Bay Street ":

> *"It is obvious that all of the gatekeeping mechanisms designed to protect investors and to ensure a fair and efficient marketplace have either failed or shown serious shortcomings. Auditors, boards of directors, individual directors, lawyers, investment bankers, rating agencies, standard setters, analysts, regulators and lawmakers have each in their own way failed the public. Their failures have produced what many are referring to as a crisis of faith in the entire market system.*

John Lawrence Reynolds is well known for writing on financial and investment matters. His book "Free Rider: How a Bay Street Whiz Kid Stole and spent $20 million" describes how a broker with a major brokerage used fraud and deceit to take money from his clients. In his latest book "The Naked Investor; Why almost Everybody But You Gets Rich on Your RRSP" Reynolds writes:

> *"It is my view that avoidable RRSP/RRIF losses are rooted deeper than investor inattention and advisor malfeasance, They represent an attitude that permeates the industry at the top levels of many brokerages, including those owned by Canada's chartered banks. The evidence seems to indicate that pressure is applied on individual brokers to maximize their commissions to the detriment of other more critical concerns, including the growth and security of the client's investment portfolio."*

Reynolds conclusions reflect those of many industry participants who express their opinions confidentially. Recently a retired registered representative, upon reading the Naked Investor and an article in the National Post by Jonathan Chevreau, was prompted to write an Open Letter to Canadians. In this letter he described some of the corporate behaviour he had witnessed during his career. It seemed to be from the heart and very critical of the investment industry attitudes that seem to be systemic. The letter was carried on several websites. It was not surprising when the letter disappeared within a few days.

It is not the first time we have seen what appears to be very deliberate attempts by industry to cover up the dark side of the business. It is not so many years ago that two small investors took a major bank owned brokerage to court over Bre-X, billed as the scam of the century. As the "scam of the century" impacted negatively on most Canadian investors, either through direct ownership of shares or through owning mutual funds, it seemed that the trial would be a major newsworthy event.

On the first day of the trial two Ottawa evening papers carried coverage. Not surprisingly the Toronto papers and the rest of the news media seemed strangely uninterested in

reporting on the involvement of a major bank-owned brokerage in the "scam of the century". That evening the Ottawa papers were also silent.

If the media is unable to alert investors, then who can provide investor protection?

Delegation of investor protection to self-regulatory organizations results in a conflict of interest. SROs mandate should be limited to regulating its members.

All of the evidence indicates that investor protection is lacking and that current enforcement does not discourage widespread industry practices of wrongdoing that result in investors unfairly losing their life savings. It is not individual "rogue" brokers that are responsible but the problem seems systemic and to extend to the top.

Investor Protection should be delegated to a government authority on a national basis. The CARP/SIPA report "GIVING SMALL INVESTORS A FAIR CHANCE" was presented to the Honourable Tony Ianno in September 2004. The report recommends:

> *"In order to ensure investor protection, a federal Investor Protection Act should be passed which includes the establishment of a single, national independent Investor Protection Agency (IPA)"*

This authority would maintain a central register for companies and registered representatives as well as an indication of any disciplines, lawsuits or complaints registered. This registry would assist regulators to avoid situations like that of Richard Smith and Synlan Securities. Smith was convicted in criminal court in Ontario but subsequently was registered by the Ontario Securities Commission. When they later learned of his criminal conviction they banned him from Ontario. The BCSC subsequently registered Smith who worked in British Columbia. Later he was also banned in B.C.

A national Investor Protection Agency would address at least some of these issues. Such an authority would also serve as a single point of access for investors and regulators with regard to registrants, and work in conjunction with the regulators. It would have the power to monitor and cause to be investigated such situations that appear to warrant investigation.

Until there is a national authority, provincial regulatory authorities should establish a panel to hear or review complaints from small investors. These complaints would provide direction for further investigation. The panel should be composed of non-industry representatives drawn from the judiciary and from consumer organizations.

Recommendation –

The regulators need to take a fresh look at investor protection and establish an authority or office with a mandate for investor protection, as recommended in the CARP/SIPA report.

All provinces and territories should follow Manitoba's lead and amend provincial/territorial legislation to allow the provincial regulators to order financial compensation (restitution) to an aggrieved investor after an administrative hearing."

Regulators should delegate a substantial portion of their resources to individual investor protection.

Regulators should be empowered to take more timely action, and to establish rather than negotiate, appropriate penalties for offenders.

Regulators should not accept industry working to recommended guidelines and best practices. Mandatory requirements combined with improved enforcement and effective penalties are essential.

Regulators need to examine the attitude of the industry's leaders and encourage reform before it becomes necessary and possible to have a crown commission examine the investment industry.

4. Investor Education

While investor education is not the panacea that some proponents would suggest, it is important that Canadians receive financial education in the school curriculum to prepare them for their productive life so they will be in a better position to make informed decisions with regard to their financial resources.

Many Canadians know very little about the investment products that are being held in their Registered Retirement Savings Plans. Most will know that they have mutual funds, segregated funds, securities, or some other type of financial product, but many will not understand the details of their investments, the costs of buying and selling their investments, or the risks of the investment products themselves.

There is such a proliferation of investment products that individual investors are not able to evaluate them. Indeed many investment advisors are not able to evaluate these products or in the alternative they deliberately sell products that are inappropriate for their clients.

New products are being developed on an ongoing basis thus aggravating the problem for small investors, and making the qualification and continuing education of investment advisors ever more necessary.

Many agencies recommend a leveraged investment strategy for all clients regardless of age or financial situation without ensuring that the investor understands the additional risk that accompanies this strategy. Investors accept inappropriate products and inappropriate investment strategies recommended by their investment advisor because they lack investor education and trust that their advisor is qualified and that the industry is well regulated.

With the evolvement of the investment markets and the volatility in today's markets the risks appear much greater than ever before. When newly developed products that are not fully understood by the sellers because they have not been market tested are combined with leveraging strategies the risk of disastrous loss is increased manifold.

Recommendation –

Investor education should be included in school curricula across the country. Regulators must recognize that Canadians are not educated as investors and ensure that safeguards for uneducated investors are provided in the regulatory system.

Regulators must recognize that investor education is only part of the answer and education of investment advisors is essential. Regulators should make industry and investors aware that the investment industry is knowledge based, and therefore carries a fiduciary duty that endures.

5. Regulation

Glorianne Stromberg's 1998 report entitled "Investment Funds in Canada and Consumer Protection" states:

> *"The unsatisfactory situation for the consumer/investors that results from continuing the fragmented regulatory structure reinforces the need for an integrated regulatory and supervisory structure"*

Not much has changed as confirmed by the Wise Persons Committee report in December 2003. A regulatory system will not provide investor protection if enforcement allows industry to circumvent the rules and regulations in place, or participants are able to satisfy the regulators by paying small fines rather than being forced to make clients whole and pay punitive fines.

Rules and regulations without enforcement are no better than no rules at all. Our society is based on trust and most ordinary Canadians expect the rules to be followed. They also trust that the government and the regulators will ensure that the rules are fair and that investors will receive fair treatment.

The Canadian regulatory framework includes provincial responsibility for regulation of securities, pensions and insurance. This results in numerous regulatory organizations across the country and the possibility of duplication of effort and lack of co-ordination amongst regulators. A national regulator would resolve these problems.

One of the many regulators is the Investment Dealers Association (IDA). It is one of Canada's SROs and bills itself as "Canada's national self-regulatory organization for the securities industry". The IDA claims to regulate the activities of investment dealers and states that investor protection is a top priority.

The IDA's stated mission is to protect investors and enhance the efficiency and competitiveness of the Canadian capital markets. However it also states:

> *"Under supervision of securities commissions, it aims at a balanced approach to regulation taking into account the often complementary, but occasionally conflicting, goals of investor protection, efficiency and competitiveness."*

This IDA mission statement is an admission of the inherent conflict of interest between industry regulation and investor protection.

Anecdotal evidence from small investors indicates that the delegation of investor protection to the SROs does not provide adequate protection. A typical comment received by SIPA:

> *"THE REGULATORY BODIES DO NOT PROTECT THE INVESTOR."*
> A small investor - Nov 2003

The Wise Persons Committee Report issued in December 2003 strongly recommends a national securities regulator. The WPC reviewed the regulatory system and many previous studies and reports prior to arriving at their conclusion.

With regional diversification it is not surprising that the provinces are not unanimous that there should be a national organization although most believe in harmonization.

Québec stands out as appearing to be the most socially responsible province and has evolved a new Autorité des marchés financiers reporting to the Minister of Finance. Québec has effectively created a single regulatory system for the province by creating the new Autorité that combines the financial services regulators. The website of the Autorité states:

> *"The Autorité des marchés financiers administers different laws and regulations applicable to Québec's entire financial sector. For each of four sectors of activity, the laws, regulations, guidelines, and all other legal texts concerning the organizations merged into the Autorité."*

This could be an appropriate approach but still fails to adequately address the issue of consumer protection.

The Honourable Yves Seguin, Quebec Minister of Finance, wrote to SIPA May 5,2004:

> *"An indemnity fund exists in Quebec for the victims of fraud in insurance and in mutual funds. We are studying with interest the possibility of expanding this indemnity to the victims of fraud in securities sector as well."*

Québec seems to be far in advance of the other provinces with their approach to investor protection.

In Manitoba the provincial government has taken an initiative that should prove beneficial for small investors in Manitoba. Greg Selinger, Manitoba Minister of Finance, advises:

> *"The Government of Manitoba shares the views of the Small Investor Protection Association (SIPA). That is why we amended the Manitoba Securities Act in 2003 to allow the Manitoba Securities Commission to order financial compensation (restitution) to an aggrieved investor after an administrative hearing."*

There should be no impediment to all the provinces and territories following suit. The Manitoba Minister of Finance advises that the new legislation has already had a beneficial effect for small investors because companies are now more ready to settle disputes.

For many years it has been said that the national regulator in the United States, the Securities and Exchange Commission, was much superior to our fragmented Canadian approach to regulation. However it was not until Eliot Spitzer took a fresh approach and proceeded to attack the investment industry on the basis of investment protection, with his Bureau of Investment Protection, that extensive wrongdoing by the investment industry was revealed to the public and corrective action taken.

Spitzer was empowered to act by legislation … the Martin Act (1921) and the Sarbanes/Oxley Act (2002), but also was assisted by TruthTeller (or whistleblower)

protection that encourages TruthTellers to come forward. Indeed it was a Ms. Harrington, who worked in the mutual fund industry, alerting the Attorney General's office of some of the activities of wrongdoing that enabled investigators to do their job.

An article in the New York Post January 26, 2004 has captured the situation in the United States, and this applies equally to Canada. The following is an excerpt:

> *"Whether you are talking about research or mutual funds or specialists, there has been a failure to properly question behavior that they know about before anyone else. Everyone of those issues was understood by the industry and not responded to."*

Canadian regulators require updated legislation to allow them to deal with today's investment marketplace. They must be able to move more quickly to minimize the number of potential victims due to wrongdoing that often continues for years while the regulators are investigating or engaged in lengthy court battles.

The penny stock dealers are a prime example. It took the OSC several years of investigation and litigation to have the right to deal with the dealers and meanwhile the dealers continued to sell worthless stock, some of it fraudulent, to an unsuspecting public. When the OSC was finally able to proceed, several dealers voluntarily closed their doors.

Industry appears in favour of self-regulation and Recommended Guidelines and Best Practices. However, the investment industry has demonstrated that they are not only unable to follow rules and regulations established by the regulators but also have difficulty following their own corporate guidelines. Some industry executives seem to believe that the established rules and regulations are merely guidelines and do not need to be followed.

Many in the industry seem to believe that longstanding practices that are contrary to rules and regulations may acceptably be followed. There are those in the industry who demand practices that may maximize profit but are not in the best interests of the investors whose savings are used to generate commissions and resultant profits.

There is no doubt that guidelines should be established for acceptable business practices but these should be mandatory if they are to have any effect and not be solely for window dressing. These guideline should address the many issues being discussed including:

- Qualification of representatives
- Maintenance of records
- Qualifying clients
- Disclosing levels of risk associated with various products
- Disclosing risks associated with leveraged investments
- Disclosing actual performance of client accounts
- Developing age related investment strategies
- Providing regular informative statements to clients

There appears to be no common understanding of risk definitions. Investors tend to think that income means their investments will produce an income but not grow, growth means the investments will grow over time but will not provide income, and speculation is to be avoided because of the risk of loss.

On the other hand some in the industry seem to believe that all investment involves risk and that risk could be the total loss of the investment.

Industry generally fails to provide statements that fully inform the investor. Many statements simply show this month versus last month, or market value compared to book value. These types of statements do not provide small investors sufficient information to enable them to properly monitor their investments without considerable effort and record keeping on their part. Many investors don't understand their statements.

Good reporting is available. Clients who are aware can ask for and receive meaningful reports. Generally sophisticated investors are able to receive reports that provide on a monthly basis the performance of individual investments and the annualized rate of return of their investments. This enables them to take appropriate action.

It seems that some in the industry do not believe in disclosure or transparency and some have in fact resorted to fraudulent reporting to prevent clients from learning the truth. This type of behaviour should result in punitive measures against the registered representative and against management for allowing it to happen.

Recommendation –

Regulation should be consistent on a national basis so that all Canadians are treated fairly and equally.

Regulators should have the power to collect fines from companies and representatives even if they leave the industry.

Regulators should require SROs to develop mandatory guidelines rather than relying upon recommended best practices that have no authority for implementation. Mandatory requirements combined with improved enforcement and stringent penalties are essential.

Regulators should investigate wrongdoing beyond the immediate complainants to identify all victims of the wrongdoing and levy appropriate penalties for perpetrators and supervisors including a requirement to pay restitution to victims.

Regulators should be empowered to take more timely action and to establish appropriate penalties rather than negotiating settlement agreements with offenders.

6. TruthTeller Legislation

The federal government has introduced TruthTeller legislation for civil servants and this should be expanded to all Canadians. Canadian TruthTellers who have come forward in the past have not only lost their jobs but also their careers. They do not receive support. TruthTellers should be protected and supported, not only because of their actions but because it will help the regulators to do their job with fewer resources and less cost.

The death of Kent Shirley in December 2004 is tragic. Kent had identified what he believed to be wrongdoing and reported to the Saskatchewan Securities Commission and turned over evidence that he believed supported his allegations. No one knows the details leading to his death but it must be devastating for a young man who believes he is doing what is right to discover that there is no support and that his chosen career is jeopardized.

It is not possible for regulators to monitor all the activities of the investment industry. Market Regulation Services is able to effectively monitor computerized market trading but selling processes are not so easily monitored. Inevitably individuals become aware of wrongdoing and should be encouraged to report to the regulators. Police work depends upon informants. Spitzer was aided in his work by TruthTellers. A Ms. Harrington alerted his office to mutual fund industry wrongdoing.

It is time for our government, regulators and police to address this issue and provide appropriate legislation, regulation and communication to protect and reward TruthTellers for coming forward. TruthTellers should be protected from threats and reprisals.

The practice of SROs reporting back to member firms when registered representatives raise issues with the regulator should be prohibited. This feedback leads to threats or sources of information being compromised.

Recommendation –

The Joint Forum should advocate that Federal TruthTeller legislation subsequent to the Fraser Report be extended beyond the federal government and apply to provincial and municipal governments, corporations, the investment industry and the regulators.

Regulators must make provision to protect TruthTellers who are prepared to speak out to correct widespread practices of wrongdoing.

Regulators should prohibit SROs from revealing sources to member firms.

7. Registered Representatives

The investment industry advertises that small investors can place their trust in the industry. The investment industry is knowledge based and therefore owes a fiduciary duty to the investor.

In order to fulfill that fiduciary duty it is incumbent that the industry ensures that registered representatives acting as investment advisors and selling financial products are properly educated and trained to be competent to offer advice that has such a major impact on the lives and well-being of small investors.

The evolving marketplace has resulted in the four pillars of financial services developing similar products that appear very much the same to small investors. Mutual funds, segregated funds, pooled funds and other financial products are not understood by average Canadians; and so they must rely upon and place their trust in their investment advisor. In many cases the investment advisor is no more than a seller of financial products and may not himself understand the risks inherent in the products being sold or the investment strategies being recommended by his company.

Sellers of financial products are commonly rewarded on the basis of commissions and bonuses based upon what and how much they sell rather than client service.

Often the investment strategies employed by investment advisors are the same regardless of the investor's age or financial situation and are directed from the top down. It is difficult to imagine that an investment strategy of leveraged high risk investments is appropriate for seniors in their 70s or 80s, yet it happens regularly. These circumstances are common whether the product is funds, securities, limited partnerships or other financial products.

Recommendation –

Regulators should ensure that registered representatives have the requisite knowledge to understand the long term functioning of the markets and the risks associated with various investment products and investing strategies.

Registered representatives should be made aware that they have a fiduciary duty as investment advisors that endures and that they have a lasting responsibility to do what is best for their clients.

All registered representatives should be listed in a central registry with their qualifications and any limitations or disciplines listed. This information must be made available to investors.

8. Disclosure and Transparency

There is a lack of disclosure and transparency in the investment industry generally. When disclosure is made, as is the case with prospectuses, it is often in language that ordinary Canadians do not understand.

Investment advisors often fail to provide sufficient information to investors and encourage investors to depend entirely upon them to look after the investments. That is until there is a problem. Then it seems the investment advisor claims he has only been there to take instructions from the investor and claims the investor is now sophisticated.

Registrants should be required to disclose the risks associated with any recommended investment strategy at the earliest opportunity and prior to completing the New Account Application Form.

Registrants should be required to disclose the risks of every investment product at the point of sale and how that will be impacted by the chosen investment strategy.

Information technology enables companies to provide information in a way that was not possible a few short years ago, yet many Canadians are still not receiving statements that are sufficiently informative to enable them to make appropriate decisions regarding their investments.

While universal investor education would help to relieve this problem, the investment industry should take the initiative to provide meaningful reports to investors. Failure to provide sufficient information to properly inform investors should be considered as negligence at best, or deliberate attempts to deceive at worst.

It is also incumbent on the regulators to inform investors of wrongdoing or they become culpable by contributing to the investors loss by not revealing significant information. There should be a central registry where investors can make inquiries. This registry would also assist regulators and police in their work.

In many cases of wrongdoing the disclosure is couched in language that is not informative. "Conduct unbecoming" and "failure to keep proper records" can cover up fraudulent actions. When regulators uncover wrongdoing there should be full and complete disclosure.

Recommendation –

Regulators should require agencies selling financial products to make point of sale disclosure of pertinent information regarding investment risks and costs of purchase and sale in a form that is understood by the investor.

Regulators should provide Mandatory guidelines for investors' statements to disclose essential information including risk assessments and annualized rates of return compared to appropriate benchmarks.

Regulators should maintain a central registry of registrants and disciplines and disclose this information to investors on demand.

Gag orders should not be allowed on dispute settlements. There should be disclosure rather than cover-up.

9. Complaints Procedures

Investors who do experience significant loss may expect to be made whole if the loss is due to industry wrongdoing. However the current regulatory and supervisory structure makes the dispute process complicated and painfully slow. Some victims take years to have their complaints addressed by the regulators only to find out that the regulators will not get their money back, but only investigate to determine if the rules are broken.

Many of the victims find that they do not even have the chance to tell their side of the story to the regulators. If their investment advisor contradicts their written submission, the regulators often say they do not know who to believe and so close their files

Many investors complain that the Investment Advisor

- Did not explain the products fully
- Did not complete a Know Your Client (KYC) form and return a copy
- Did not explain the risks associated with the investment
- Did not provide a prospectus
- Failed to provide meaningful reports
- Did not revise the KYC form when there were major life changing events
- Overstated income and assets in the KYC form
- Made discretionary trades without proper authority
- Failed to act on instructions
- Encouraged the investor to borrow for investing without explaining the risk
- Traded excessively to generate commissions
- Purchased inappropriate products
- Forged signatures

The complaints vary but most are based upon breach of trust, unauthorized trading and inappropriate investments that have resulted in major loss. Many of the victims are seniors, but victims come from all walks of life.

The common complaints are that the value of the account has suffered serious degradation. In the worst cases the investor has been concentrated in one product or one type of product, and has been leveraged with a bank loan, a mortgage loan, or a margin loan.

In all cases the investor has trusted his investment advisor.

The unfortunate aspect is not so much that investors are victimized by loss, but the victims are often treated shabbily by the industry when they attempt to resolve the dispute. Dr. Pamela Reeve addressed this issue in her submission to the Ontario Securities Commission regarding the Fair Dealing Model on August 9, 2004.

Dr. Reeve provides an analysis of client relationships with the investment industry when complaints are pursued, and suggests that these relationships are impaired relative to the factors that constitute fair dealing, because of inherent conflicts of interest. In her analysis Dr. Reeve concludes:

> *"there are strong reasons for the Ontario Securities Commission to consider stricter standards of business conduct for firms that provide these (investment) services."*

It may be that it is not only a lack of knowledge on the part of the advisor but in some cases it seems there is a culture of non-compliance with rules and regulations as well as normal levels of morality and ethics.

The CSAs report that the top five complaints relate to:

1. Suitability
2. Customer service
3. Unauthorized trading
4. Disclosure
5. Scams and frauds

Recommendations –

Regulators should impose mandatory complaints procedures requiring complaints to be handled in a timely and fair manner.

Regulators should require companies to make clients whole, whenever complaints are precipitated by wrongdoing resulting in investor loss.

Regulators should monitor complaints procedures and require all agencies selling financial products to report all complaints received to a central national registry.

Regulators should carry out periodic audits to ensure that proper complaint handling procedures are followed and record all reports of improper handling.

Regulators should be empowered to order forensic audits whenever complaints, or TruthTellers, indicate there are unacceptable practices occurring, and to order the companies to reimburse the costs of these audits, as well as pay restitution to all those who are found to have lost money due to the wrongdoing.

10. Dispute Resolution

The Purdy Crawford Report for Ontario referred to a court decision in which the judge;

> *"noted with regret that the investors who were victims of the improper conduct in that case would have to pursue costly and complex litigation to recover their funds."*

The Committee recommended that;

> *"the Act be amended to include a provision permitting the Ontario Court of Justice to make an order, where appropriate, that the defendant compensate or make restitution to persons who have suffered loss of property as a result of the commission of an offense by the defendant."*

There are industry sponsored dispute resolution mechanisms but these are designed to arbitrarily reach a resolution rather than to arrive at a just decision. These mechanisms seem to display an industry bias.

The civil courts appear to be the only means to achieve a just resolution, but even the civil courts appear unable to provide true justice. The legal process is long and costly and there is no recognition of the detrimental impact on the victim's life. The industry tends to cover up and use legal tactics to defend vigorously situations that appear indefensible.

The industry employs a strategy of high priced lawyers, legal maneuvering and delay. The tactics employed coupled with a judiciary that is not always conversant with the ways of the investment industry can result in justice denied.

The small investor may have trouble getting a capable lawyer to take his case because most of the top lawyers are retained by the industry, or do not want to be tainted by acting for investors. The cost of top lawyers can be prohibitive for investors who have lost everything, and seniors are often so devastated by their losses that they do not have the will to fight a legal battle.

One senior securities litigation lawyer confided that the judge who was hearing a particular case had previously presided over a family law court. The lawyer acting for the Plaintiff said he spent most of the first day with his opening remarks to brief the judge on how the securities system worked and the importance of the Know Your Client form. It seems that judges are not so much different from average Canadians when it comes to knowledge of how the investment industry operates and the laws and regulations governing the industry.

Many have called for a special court to deal with white-collar crime with a judiciary educated and trained to deal with these types of issues. The education and training should include not only the applicable laws and regulations, but also the impact on victims of white-collar crime.

It is time that white-collar crime is recognized as a serious issue and that its impact on people's lives can be sufficiently devastating as to be life threatening. Perpetrators should be punished for their wrongdoing and made to pay restitution, punitive damages and fines that discourage repeat offences. Currently it seems that many registrants believe the risk of being caught is slight, and if caught the fines are sufficiently small they can be considered as simply the cost of doing business.

Many small investors do not have the resources to proceed with civil litigation. Special consideration should be given to seniors, or those without resources to afford litigation, by providing funding for civil litigation when regulators are unable to resolve the dispute.

Recommendation –

Regulators should not delegate dispute resolution to SROs.

Regulators should ensure that investors have access to alternate dispute resolution that is not industry sponsored.

Regulators (not SROs) should investigate cases of wrongdoing to identify all victims of the perpetrators, and order restitution to be paid by the companies employing the perpetrators.

A special court for investment industry disputes should be established with a judiciary educated and trained for investment industry litigation to provide fair and timely resolution.

Special consideration should be given to seniors, or those without resources to afford litigation, by providing funding for civil litigation when regulators are unable to resolve the dispute.

Regulators should establish a special fund for this purpose that would be funded by industry with special assessments for those agencies found guilty of wrongdoing.

11. Disciplinary Action

In a February 4th, 2004 article in the Pittsburgh Post-Gazette by Len Boselovic entitled "Federated to repay $7.6 million to investors harmed by trading" he writes:

> *" 'We are committed to punishing not just those who engaged in the trading but also those who facilitated it,' said Stephen Cutler, director of the SEC's enforcement division."*

Regulators have not been able to discourage widespread practices of wrongdoing in part because they appear not to have the power to order penalties but must resort to negotiating settlement agreements.

The penalties contained in settlement agreements often pale in significance to the gains made by those involved in wrongdoing.

Industry faced with the choice of excessive profit due to wrongdoing, or taking the risk of getting caught and paying minimal fines, often choose profit over social responsibility.

Individually the leaders of industry may seem like honest caring individuals. However the pressures for performance affect the leaders and representatives alike.

Anecdotal evidence suggests that it is not unusual for registered representatives to engage in practices that they believe are inherently wrong because it seems to be accepted practice and not to do so could jeopardize their careers. Others simply seek a new career path.

Wrongdoing should be taken seriously and strict penalties imposed. There are no rogue investment advisors working for large companies. Information technology in use today enables managers to monitor all trading activity and identify activities that should raise red flags.

Recommendation -

Managers and directors failing to properly supervise their representatives should be held jointly responsible and share in penalties levied for wrongdoing.

Managers and directors that are found to be repeat offenders where the wrongdoing results in serious harm to investors should be banned from the industry nationally.

Companies and individuals who breach the rules should be listed in a central registry that contains their transgression and the penalties imposed. This alphabetical list should be available to the public to enable investors to carry out due diligence.

12. A Final Comment

Our Government, the regulators, and the leaders of the investment industry have a social and moral responsibility to ensure that this essential industry is operated in a moral and ethical fashion, as well as a legal fashion.

Canadians deserve a well-regulated industry upon which they can rely and be entitled to fair treatment.

Industry representatives or companies with a culture of non-compliance should not be allowed to subject investors to financial predation and subsequent abuse.

Regulators should not allow industry participants to flaunt the rules and regulations and then rely upon legal tactics to vigorously defend situations that are morally and ethically indefensible.

TruthTeller protection must be enhanced to protect those who come forward so they may do so without fear of reprisal. TruthTellers will assist regulators in their role of regulating the investment industry.

Enforcement must give priority to protecting investors. Some regulatory resources should be allocated for small investor protection issues rather than committing all the resources to addressing major corporate issues.

White-collar crime must be recognized for the extreme impact it has on victims and special courts should be established with a judiciary that is not only well briefed on the intricacies of the investment industry but also cognizant of the impact on and the needs of the victims.

An Investor Protection Agency as defined in the CARP/SIPA Report would resolve many of the issues related to investor protection.