Submission to the Expert Panel on Securities Regulation in Canada

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15 July 2008

Thank you for the opportunity to make a presentation to the Expert Panel on Securities Regulation on 18 June 2008 in Toronto. My present comments will summarize and expand on the views presented at that meeting with regard to how best to improve securities regulation in Canada, drawing on global best practices. My focal recommendation relates to the establishment of a Canadian equivalent to the Financial Services Consumer Panel in the UK.

As I am sure the Panel is aware, there have been previous initiatives aimed at considering the reform of securities regulation in Canada. In particular, I refer to the report of the *Wise Persons' Committee to Review the Structure of Securities Regulation in Canada* (WPC). In their letter dated 17 December 2003 to the Minister of Finance, which accompanied their report, the Committee writes:

> *There is a new and unprecedented consensus for change. … Canada's regulatory structure is out of step with the needs of its capital market participants and it is out of step with the rest of the world. Reform of Canada's securities regulatory structure and the development of a capital markets strategy are issues of fundamental importance for every Canadian.*[1]

Following this report, the Investment Dealers Association of Canada, a self-regulatory organization, initiated a Task Force with the goal of recommending *"revisions to Canadian securities legislation and regulation to achieve a dynamic, fair, efficient and competitive capital market"* (see Appendix A of the Final Report, link following).

Final Report (October 2006): http://www.tfmsl.ca/docs/Volume1_en.pdf

The Task Force report, titled *Canada Steps Up* (continuing the above metaphor), contained 65 recommendations drawn from the research studies commissioned for the study (pp. 7-16). An additional set of recommendations is contained in chapter 11 of the Final Report. This second set is described as *"recommendations, which we do not necessarily endorse."*

One of the research studies, titled *"Involving Consumers in Securities Regulation,"* was commissioned from London School of Economics Professor Julia Black, an expert on regulation. This study is available at the following link:

http://www.tfmsl.ca/docs/V6(9)%20Black.pdf

[1] Michael E. J. Phelps et al, *"It's Time: Report of the Committee to Review the Structure of Securities Regulation in Canada,"* Department of Finance Canada, December 2003.

Professor Black investigated several categories of consumer/citizen involvement in securities regulation. These included investor education, consumer advocacy, consultation with retail investors, and their active participation *"in the regulatory process as a means for determining their interests"* (p. 611 above study). Although Black recommended that retail investors should have the opportunity for greater involvement in policy making, none of her 30 recommendations were included in either of the two sets of recommendations in the Final Report of the IDA Task Force.

In November 2005, the Ontario Securities Commission announced the Investor Advisory Committee (IAC), which had its first meeting in January 2006.[2] This committee was created following the May 2005 OSC Investor Town Hall as an ongoing forum to provide the Commission with access to retail investor needs and concerns. The importance of this interface was emphasized on repeated occasions by the Commission.[3]

The IAC was in its initial phase when Julia Black wrote her Task Force report. On pp. 616-629 of her study, she discusses the OSC Committee and compares it with the advisory body established by the Australian Securities and Investment Commission as well as the UK's Financial Services Consumer Panel (the latter is covered in greater detail). In her study, Black makes the following recommendations, among others, for the expansion of consultation with retail investors:

> *3.6 Expand the role of consumer representatives in all securities regulators, including the CSA, through the establishment of investor advisory committees, consumer panels or similar bodies.*
>
> *3.7 Ensure all investor advisory committees / consumer panels have a clear remit are adequately remunerated, have an independent budget to allow them to commission research; have timely access to all relevant information, including research conducted by the regulator or others, and are given the necessary training to enable them to be effective.*
>
> *3.8 Consumer representatives should publish a summary of their activities on an annual basis, including their criteria by which their priorities are established.* (pp. 628-29)

The implementation of these and other recommendations would have helped to bring the OSC's initial foray in consulting with retail investors into line with what is arguably best practice in other jurisdictions, most notably the UK. Nevertheless, the IAC was abandoned at the conclusion of its initial two-year term, as indicated in an interview with OSC senior management reported in *Investment Executive* in April 2008.[4]

Based on my experience as a member of the OSC's Investor Advisory Committee, my past advocacy experience and that of others, and in view of the evident changes that are being considered in the securities regulation and enforcement regime in

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[2] Press release: http://www.osc.gov.on.ca/Media/NewsReleases/2005/nr_20051129_osc-investor-advisory.jsp

[3] See the compilation of documents at: http://investorvoice.ca/IAC/IAC_index.htm

[4] http://www.investmentexecutive.com/client/en/News/DetailNews.asp?id=44353&IdSection=27&cat=27&BImageCI=1

Canada, I would recommend that an independent, statute-based, funded body, equivalent to the UK consumer panel, be established to monitor and advise the regulatory oversight of the financial services industry. Such a body would review and comment on regulatory initiatives from a consumer perspective and would report to the public.

The following article, published in December 2007 in *Investment Executive,* presents my overview of the consultation framework in the UK (*"Consultation framework needs makeover: The British approach to financial reforms should be considered for use in Canada"):*

> http://www.investmentexecutive.com/client/en/News/DetailNews.asp?Id=42235&cat=25&IdSection=25&PageMem=&nbNews=&IdPub=

Involvement of third parties in effective regulation and the protection of the public interest

A supporting view with regard to the role of independent third parties in strengthening the regulatory and enforcement regime is provided in the submission of Professor Laureen Snider of Queens University. In her submission, she makes reference to the long-standing recognition in the academic literature that it is essential to structurally incorporate non-governmental third parties into regulatory systems—i.e., which do not represent either the industry or the regulator. She emphasizes that the role of third parties is especially important in regulatory regimes, which have problems with weak enforcement. There is significant consensus that Canada is affected by such problems in the area of securities enforcement.

The need to include third parties in the regulatory landscape was recognized in the environmental sector in the context of the tainted water tragedy in Ontario in 2000, which led to the Walkerton Inquiry. The following passage is from the 2001 report submitted to the Inquiry by the Pembina Institute, which assesses different delivery models for drinking water protection in Ontario:

> *… there is a well-documented propensity for specialized bodies such as agencies or regulatory commissions to develop very close relations with regulated entities. Specific mechanisms to assist public interest and community based intervenors in policy-making and regulatory processes are needed to counteract this tendency.*[5]

Looking back at the various reports on securities regulation that have been produced over the past several years, I can find no instance where there has been a recognition of this *"well-documented propensity"* nor the proposal of a structural remedy to address it. This is overlooked, for example, in the report of the Wise Persons' Committee, which saw collaboration between regulators and regulated entities as *exclusively a strength* of the present system:

[5] Mark S. Winfield, Ph.D. and Hugh J. Benevides, LL.B., *"Drinking Water Protection in Ontario: A Comparison of Direct and Alternative Delivery Models,"* Issue Paper Prepared for Part II of the Walkerton Inquiry, Pembina Institute, October 2001, p. 45.

> *A local [regulatory] presence also facilitates dealings between the regulator and issuers and intermediaries. Regulators and capital market participants can meet "across the desk" to share perspectives, gain mutual understanding and resolve issues in a constructive and efficient manner.*[6]

In contrast, the UK system exhibits the desirable feature of 'tripartism'. The Consumer Panel functions as a third-party, monitoring and advising the Financial Services Authority (FSA) in its regulatory oversight of the industry. In principle, this kind of structure strengthens regulatory effectiveness, compliance, and public accountability.

Reliance on volunteer members of the public to monitor securities regulation and enforcement initiatives and intervene in the public interest is unfair and potentially ineffective given the lack of accountability to such individuals and groups on the part of regulators and government.

As Laureen Snider points out, third parties need to be "embedded" in the system as observer/intervenors to fulfill this function effectively and efficiently. While the voices and views of individual volunteers may be easily ignored or marginalized, the perspective of an independent body such as the UK's Financial Services Consumer Panel must be taken into account. An examination of the material at the Consumer Panel's website will give an idea of how this body exercises its advisory role in relation to the FSA's regulatory initiatives: http://www.fs-cp.org.uk/.

In the UK, the accountability of the regulatory authority to the Consumer Panel is based in statute. Previously, I forwarded to the Expert Panel a copy of the relevant pages from the *Financial Services and Markets Act 2000,* which formally recognizes the FSA's *"duty to consult"* with the Consumer and Practitioner Panels.[7] This includes a *"duty to consider representations"* received from these panels and to respond in writing with reasons in the event of disagreement. Such accountability is weakened in the absence of supporting legislation. Its effectiveness would be further undermined if the requisite consumer body were not provided with adequate funding and facilities.

In the UK, funding and facilities for the Consumer Panel is provided by the independent regulator, the Financial Services Authority (FSA), and ultimately by fees levied from the industry. The same funding model should be considered for adoption in Canada.

A move to principles-based regulation is being considered by the present Expert Panel for adoption in Canada, based on the UK model. It should be kept in mind that an important function of the UK Consumer Panel involves monitoring this regulatory reform. For example, moving to a principles-based system would circumvent certain aspects of the present consultation process, where statutory and self-regulatory organizations publish rules for public comment. In the move away from a rules-based system, firms generate *internal guidance* on how to apply general principles within their business environment to achieve regulatory outcomes. In the UK, the Financial Services Authority responded to concerns about this, expressed by the

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[6] Michael E. J. Phelps et al, *"It's Time,"* p. 19.

[7] Consultation arrangements are covered in sections 8-11 of the UK legislation, available at the following link: http://www.opsi.gov.uk/acts/acts2000/pdf/ukpga_20000008_en.pdf

Consumer Panel, by making a commitment to allow the Panel to review and comment on industry guidance referred to the FSA for confirmation.[8]

The existence of such a Panel also would strengthen the accountability of the securities regulator to the public. The proposal of the Wise Persons' Committee, that the regulatory structure should be accountable to the public only *"through their elected representatives,"* is inadequate given the nature and complexity of financial matters and the (often) transitory nature of public office. [9]

A further questionable assumption in the WPC report occurs in the section on *"The Objectives of Securities Regulation."* The report states that the Committee considered these objectives *"from the point of view of three of the main users of capital markets: investors, issuers and financial intermediaries."*[10] One of the stated objectives of regulation is to *"provide sound protection for investors."* Nevertheless, the Committee assumed that

> *The **interests** of financial intermediaries, including investment dealers, brokers, financial advisors and portfolio managers, are **in line** with those of issuers and investors.*[11] (emphasis added)

Overlooking conflict of interest in the provision of financial services to investors has an immediate bearing on investor protection. If the interests investors and financial intermediaries are aligned, there is no conflict of interest. This implies that there is no need to manage conflict of interest to prevent self-serving outcomes on the part of financial intermediaries. Contrary to this assumption, one finds an explicit recognition of the need to manage conflict of interest in the Fair Dealing Model of the Ontario Securities Commission, published in January 2004.

Table A (p. 2) of the consultation paper lists several strategic objectives and outcome indicators, which serve as criteria for evaluating the FSA's regulatory performance. The first is to *"Help retail consumers achieve a fair deal."* I strongly agree with this objective, which also should be emphasized in the Canadian regulatory framework. The further question is how is the achievement of this objective to be credibly assessed and communicated to the public?

One finds in the annual report of the UK Consumer Panel an evaluation of the performance of the FSA relative to *"the outcome for consumers"* in 28 *"strategic areas".*[12] I believe the Canadian investing public would be able to have greater confidence in the performance of financial regulators in meeting their investor protection objectives if their performance were subject to ongoing assessment by an independent body established to monitor regulatory initiatives with the consumer interest in view.

SUMMARY & RECOMMENDATIONS

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[8] This consideration is discussed by Julia Black et al in *"Making a success of Principles-based regulation," Law and Financial Markets Review* 1/3 (May 2007), §6 on pp. 198-99 and 203. Link: http://www.lse.ac.uk/collections/law/projects/lfm/lfmr_13_blacketal_191to206.pdf

[9] *"It's Time,"* p. 44.

[10] Ibid., p. 41.

[11] Ibid., p. 42.

[12] See pp. 6-13 of the 2007/08 annual report: http://www.fs-cp.org.uk/pdf/annual_report08.pdf

The focal recommendation of my present submission is the establishment of an independent third party that would be a Canadian equivalent to the UK Financial Services Consumer Panel. The existence of such a Panel would respond to several issues referenced in the public consultation paper (PCP) as per my following comments.

Consultation item 1: Objectives, Outcomes, and Performance Measures

A major aspect of present considerations relates to measuring the performance of securities regulation in Canada, which may involve a move to a more principles-based approach. The laudable intention of the Expert Panel is to *"draw on the best regulatory practices of our international counterparts"* (PCP 1).

While the achievement of performance objectives by statutory regulators must involve an accountability framework that involves reporting to responsible government ministers, the UK framework also includes an assessment of regulatory effectiveness, which is conducted by the Financial Services Consumer Panel from a consumer perspective.

According to the information in the consultation paper, one of the outcome indicators used by the FSA in assessing their objective of helping retail consumers achieve a fair deal is *"Financial services firms treat their consumers fairly and help to meet their needs."*

I strongly agree with the use of this criterion in the evaluation of regulatory performance. Nevertheless, this should also be assessed and reported to the public by an independent third party, which has the consumer interest in view.

In its 2007/08 annual report (note 12 previous page), the Consumer Panel rated the FSA with regard to its efforts in bringing about the implementation by firms of the 'treating customers fairly' principle. It also rated the FSA's enforcement initiatives, its regulation of financial advice, promotions, and the pressure selling of investments by small firms. It also commented on the FSA's financial education initiatives and its communications with consumers during the Northern Rock crisis.

I recommend that *"the creation of a performance measurement framework for securities regulation in Canada"* should (1) follow the UK approach in its focus on the treating customers fairly principle and (2) include an annual assessment of the achievement of regulatory objectives by an independent, non-governmental third party equivalent to the UK Consumer Panel.

Complaint Handling / Restitution

Another important area where consideration needs to be given to the objective of helping (or better, ensuring) consumers achieve a fair deal is fair and timely restitution in the event of misconduct by financial service providers. At the present time, unlike the UK, Canada does not have an independent, statute-based financial services ombudsman. The Ombudsman for Financial Services and Investments (OBSI) was created by the industry for dealing with customer complaints. This body is only able to recommend (not order) restitution within certain limits and in my view, there is need for a stronger mechanism to ensure that abused investors receive fair and timely restitution.

Another aspect of this issue relates to significant problems with the complaint process at the dealer level. In my own case, I had to go through a protracted 4-year ordeal involving the repeated denial of my complaint about significant capital losses, which the firm eventually agreed had merit. I know first-hand the difficulties faced by retail investors in this process and have analyzed the process extensively in terms of the principles of fair dealing.[13]

In August 2003, I was informed by an IDA Inquiries Officer that the IDA finds *"very frequently"* in their own investigations that firms report *"no evidence of wrong doing"* decisions to clients when there is such evidence (as subsequently discovered by the IDA). I have since received confirmation from dispute resolution professionals that, in their experience, firms routinely deny meritorious complaints. This also is reflected in OBSI complaint statistics for the past three years in which 50-60% of decisions by investment firms have been overturned on review.[14] This overturn rate is significantly higher than that of the Financial Ombudsman Service in the UK.

There is significant exposure to risk of harm in the dealer complaint process given that the regulators do not appear to have implemented effective discipline to deter unfair decisions. Moreover, they have not cautioned investors that the dealer complaint process is adversarial and that decisions by firms about financial complaints in such a context are unreliable. The imbalance in knowledge and power in this process makes it unlikely that retail investors with meritorious complaints will be able to achieve a fair outcome in these dealings.

Investor restitution options need to be reviewed in the context of the present consideration of the structural reform of securities regulation and improvement of enforcement mechanisms.

Consultation item 2: Principles-based Securities Regulation

The consultation paper includes a list of the 11 regulatory principles used by the FSA in the UK. I am not aware of any modifications that need to be made to this list. With regard to implementation, the consultation paper notes that

> *Businesses would be responsible for establishing internal compliance controls to meet the [regulatory] outcomes. Regulators would intervene less and collaborate more with business.* (PCP 4)

As mentioned above, the UK Consumer Panel raised concerns about industry guidance referred to the FSA for confirmation and is now allowed to review and comment on this guidance prior to FSA approval. If there is a move to a more principles-based approach in Canada, the same process, involving a review of industry guidance by a consumer advisory panel, should be followed.

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[13] A summary of my analysis and papers on this issue is contained in my submission to the Investment Dealers Association (IDA/IIROC) on behalf of the Small Investor Protection Association (SIPA) at the following link:
http://iiroc.knotia.ca/Knowledge/Fetch/FetchResults.cfm?Ktype=445&filter=Regulatory%20Policy%20%2D%20By%2DLaws%2019%20and%2037%20and%20Policy%20No%2E%202

[14] See the OBSI annual reports posted at: http://www.obsi.ca/UI/AboutUs/AnnualReports.aspx

Also, as noted above, there is an increase in collaboration between the regulator and firms involved in a principles-based approach. This is further reason for establishing an independent consumer body empowered to monitor the regulatory process, as per the quotation from the Pembina Institute paper above and the comments in Laureen Snider's submission.

A paper on principles-based regulation by Julia Black and two co-authors points out that a different skill-set and attitude on the part of regulators and firms is required with this approach. They see this as potentially involving a *"significant risk"* of failure in principles-based regulation:

> *A significant change in the skills, judgement and mindset of firms is equally important. The transition from prescription to Principles is not an easy one for firms. Principles-based regulation, particularly if it takes the form of the TCF initiative [treating customers fairly], requires senior management to engage with regulatory issues at the highest level, and not regard these as things that can be delegated to compliance.*[15]

A careful assessment of this aspect of a principles-based approach is needed in the Canadian context. Having read this and other papers on the risks and benefits of principles-based regulation, I do not think this approach should be implemented without oversight by an independent third-party with retail investor interests in view.

Consultation item 4: Enforcement

The consultation paper notes that *"A more principles-based approach to securities regulation could strengthen enforcement"* (PCP 7). Nevertheless, as the paper also notes stronger, more co-ordinated enforcement is required with this approach. At the same time, there is a widespread view that securities enforcement in Canada is weak. In view of this, it seems questionable whether a more principles-based approach should be implemented before the outstanding enforcement issues have been addressed.

Consultation item 5: Securities Regulatory Structure

Although I favour a single securities regulator, I believe that accountability to the public for securities regulation should not be mediated solely through elected representatives, as proposed by the Wise Persons' Committee.

Over the past four years, the Minister responsible for securities regulation in Ontario has not been accountable regarding the failure of the government to implement a recommendation made by the all-party Standing Committee on Finance and Economic Affairs (SCFEA) in their 2004 review of the *Securities Act.*

The implementation of recommendation 9 in the SCFEA report would have seen the establishment of a dedicated task force to examine self-regulatory organizations, which have been the subject of ongoing complaints from the public over the past several years.[16] In her letter to the Standing Committee of 20 August 2004, Glorianne Stromberg emphasized the need for this review:

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[15] *"Making a success,"* p. 200.

[16] Recommendation 9, pp. 19-22: www.ontla.on.ca/library/repository/mon/9000/247247.pdf

> *There is an urgent need to review the operations of self-regulatory organizations, such as the Investment Dealers Association of Canada. The continued reliance on such organizations to protect the public is problematic and the adequacy of the OSC's oversight of them is questionable.*[17]

Nevertheless, the review recommended by the Standing Committee, which directly relates to investor protection, was never conducted. Nor has the Minister provided a response to repeated queries from a member of the public, Mr. Robert Kyle, nor the Ontario Ombudsman, as to when this will occur.[18] The lack of accountability on this issue provides further support for the establishment of an independent, non-governmental equivalent of the UK Consumer Panel, to monitor the regulatory oversight of the financial services industry from a consumer perspective.

I appreciate the opportunity to participate in the present consultation process regarding the reform of securities regulation in Canada. I look forward to reviewing the proposals of the Expert Panel and would welcome the opportunity to comment further on the outcome of the deliberations of the Panel prior to the submission of a final report.

Sincerely,

Pamela J. Reeve

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[17] Page 4: http://investorvoice.ca/Presentations/SCFEA/SCFEA_Stromberg.pdf

[18] The relevant correspondence is available at the following link: http://investorvoice.ca/Presentations/SCFEA/SCFEA_SRO_REVIEW.pdf