

Written 18th



Department of Economics • Social Science Centre

August 13, 2004

Mr. Trevor Day, Committee Clerk
Room 1405, Whitney Block
Queen's Park
Toronto, Ontario
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Re Final Report of the Five Year Review Committee

Dear Mr. Day,

I am writing you regarding the review of the Final Report of the Five Year Review Committee. While one of the major issues is whether or not the Commission should handle both its adjudicative function and its other functions, the problems of the OSC are much deeper than that. I believe the Committee has seriously understated the governance problems of the Ontario Securities Commission. I do not choose my words lightly when I say that the OSC is probably the most poorly governed securities regulator among those of the OECD countries. Virtually every vice exhibited by the corporate sector in the last five years has been replicated by the OSC over the same period. What the OSC insists are proper governance practices for the private sector are so much at odds with those under which the Commission itself operates the Standing Committee must conclude that either the private sector is massively overregulated or that nothing less than a complete overhaul of both the structure and personnel of the OSC is required. Allow me to amplify.

The Board: The OSC advocates that a majority of board members of the corporation be independent of senior management. The OSC board is composed *solely* of the Commissioners themselves.

The Compensation Committee: The OSC advocates that a majority of the Compensation Committee be independent members of the Board. The OSC compensation committee is composed of the commissioners themselves. David Brown receives more than two and one half times as much as the Chair of the US Securities and Exchange Commission. Certainly the province can find more than adequate staff for less money.

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The Audit Committee: The OSC has recently required that a majority of the audit committee members of any firm listed on the Toronto Stock Exchange be independent of management. The Audit Committee of the OSC is composed only of insiders. Enron's collapse was, in major part, due to off balance sheet manipulations. The OSC is required to put any surplus of fees and fines into general revenue of the province. To get around this it has required "contributions" of some companies it could otherwise fine. These contributions do not go into the pool for general revenue but have, in some cases, been directed toward expanding the OSC's operations into new areas. The three million dollar "contribution" of Royal Bank (in the RT Capital case) was used to fund the investor education program that is now effectively under the control of the OSC.

Accounting: The OSC asserts that it is vigilant in enforcing GAAP standards on corporations and will prosecute any company that "cooks its books". While the OSC uses GAAP to handle its bookkeeping of fees, fines and expenditures, it is largely irrelevant for its business. Let alone the off balance sheet items, the proper "accounting system" for a public entity is a measurement of net benefits from each initiative. Indeed, by law, the OSC is supposed to provide a cost benefit analysis (CBA) for each of its initiatives. The Crawford Commission was scathing in noting that in the past, *if done*, most of these were simply "boiler plate", providing no evidence to indicate the initiative yielded *any* net benefits. Furthermore, of the three recent CBAs undertaken on governance regulations (52-108,109 and 110), only the one done "in house" showed any net benefits, and the quality of that analysis would fail in any college level econometrics course. It epitomizes data mining, biased sample period selection, a dependent variable that obfuscates the effect of size, and shows no recognition of the endogenous makeup of audit committees. An accountant would characterize these actions as, at best, aggressive accounting.

Compliance: The OSC is insistent that financial corporations have a compliance officer in place. To back up her findings, this officer can appeal to the legal system or to the appropriate regulatory body. The OSC, on the other hand, can, at its discretion, establish a commission to ensure compliance at the OSC itself, but this commission would report only to the Board (i.e., the commissioners). Further, the last one of these was done in the 1980's! The *ex parte* communication between staff and commissioners – which is effectively what the separation of adjudication and other powers of the OSC is concerned with – would not be tolerated in any fair judicial system and, in terms of the financial community, is the equivalent of the breaching of the presumed Chinese wall between investment banker and analyst that generated multimillion dollar fines for the major US brokerage houses.

The government of Ontario is strongly in favor of ultimately having a single national regulator for securities markets. Other provincial governments are much less enthusiastic and, in a number of cases, are outright opposed to such an outcome. Even members of the finance industry are strongly opposed to the Ontario view. I would conjecture that much of this opposition is based on the fact that we regard a single bad regulator as worse for the industry than a mixed bag of good and bad regulators. Even if a single good regulator is best, the fear is that the OSC will attempt to co-opt the national body. The inconsistency of the existing OSC governance procedures with what they require of the private sector does not suggest a good regulatory environment would be the result of a move to a single regulatory body.

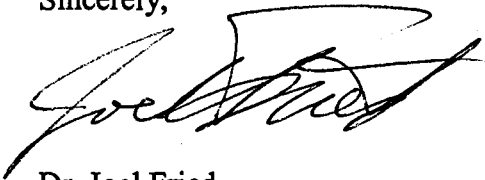
The previous government clearly made significant errors in the governance structure when they set up the Ontario Securities Commission as a crown corporation. At a minimum what is required is:

- A new structure of the Board of Directors where a majority are independent of management;
- A Compensation Committee with a majority of independent directors;
- An Audit Committee with a majority of independent directors;
- An enforceable regulation requiring cost-benefit analyses of old and any new initiatives undertaken;
- Public availability of any such cost-benefit studies; and
- A compliance process that reports outside of management to an independent board and to the Minister of Finance;

Your legislative committee has the opportunity to implement these changes at this time. Not doing so will leave the conflict between what the OSC requires of others and what it practices for itself. That is not the way to proceed in improving financial markets.

I will be out of the country from August 16-27. If, at any other time, you wish me to amplify on any of the above, please do not hesitate to call or email me.

Sincerely,



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JF/sp