Rebuilding Investor Confidence

Winnipeg Chamber of Commerce

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Winnipeg, Manitoba
October 28, 2002

Good afternoon.

Thank you for the kind introduction.

I welcome this opportunity to speak with you today about an important concern to many Canadians and an issue of particular interest to you as business people and investors.

It is a pleasure to be back in Winnipeg. Our Executive Committee and Manitoba District Council meet on a regular basis with the Premier, key government officials and the Manitoba Securities Commission to discuss securities industry regulation and the fiscal and economic policies that will support capital formation and economic growth in Manitoba. I noted that your Strategic Plan calls for a plan to drive economic investment and growth. Chambers of Commerce play an essential role in communities across Canada, creating a forum for discussion and debate on the major issues confronting our businesses and our country. I hope you will see the Manitoba securities industry and the IDA as your partners in achieving your objective.

Let me briefly tell you about our Association, its role, responsibilities and Manitoba presence and then discuss how we can all rebuild investor confidence.

The IDA is Canada's national self-regulatory organization and representative of the securities industry. Our role is to protect investors and to enhance efficient and competitive capital markets.

The IDA has a long history, although we cannot match the 130-year tradition of the Winnipeg Chamber of Commerce. Established in 1916, the Association oversees more than 190 securities dealers and 24,000 licensed brokers. Our member firms employ 37,000 people throughout Canada and across the globe. They play an essential role in our economy, raising funds for governments and businesses and fostering economic growth and employment. Seven IDA member firms have head offices in Manitoba.

Altogether 26 investment dealers are licensed in the province and operate 28 branches and 132 sub-branches, employing over 800 people.

You don't have to read the business press to know that the U.S. capital markets are under fire. And by extension, so are our markets. Corporate malfeasance, billion-dollar frauds, insider trading scandals and management greed and research analysts conflicts of interest have created a potent mix that has demoralized individual investors on both sides of the border. Their confidence in the capital markets, if not shattered, is certainly bruised. That mix has also impacted the confidence of institutional money managers, who feel they cannot always rely on published financial statements. The result is thinly traded and volatile equity markets, conditions not conducive to investing.

Calls for regulatory action to boost investor confidence in the United States are having a spillover effect here in Canada, putting us at an important crossroads in the development of our capital markets.

At issue is an important piece of US law, called Sarbanes-Oxley (SOX) — the most comprehensive securities act passed by the Congress since the New Deal legislation in 1933. This sweeping legislation deals with auditor independence, financial disclosure, analyst conflicts and corporate accountability. It requires CEOs and CFOs to certify financial statements, prohibits certain employee shareholder loans, accelerates filing of reports by directors, officers and shareholders with more than 10% of the outstanding shares and contains whistleblower protections and audit committee approval of non-audit services. The debate in Canada is whether regulators should simply adopt this legislation as is, in the interest of market integrity and regulatory harmonization, or whether we should create a Made-in-Canada solution that is tailored to our markets, thereby avoiding an excessive regulatory burden, especially on small and medium sized companies.

Rule harmonization is important for large Canadian companies that access U.S. capital markets, since they must follow US rules, including Sarbanes-Oxley. There are 177 companies listed on both the Toronto Stock Exchange or TSX and a US stock exchange.

While these companies account for 72% of the value of the TSX, they comprise only 5% of the number of companies listed in Canada.

Since SOX is highly robust, we see no need to embellish its requirements. Therefore, we believe that Canadian regulators should either accept SOX for Canadian purposes or, if we choose to develop our own rules, ensure that they do not impose an incremental burden on these inter-listed companies. Otherwise, the result will be needless regulatory complexity and conflict.

On the other hand, we should proceed carefully in considering the appropriate regime for the remaining 95% of listed Canadian companies. More than 82% have less than $500 million in market capitalization and 44% have less than $50 million in market cap. Certain US requirements would impose a significant regulatory and cost burden on these small companies, without any commensurate benefit.

I do not have to tell this audience that you cannot legislate ethics or morality. These are internal principles that people must choose to live by. Unfortunately, there will always be those who try to scam the system. But detailed rules, a US specialty, can act as a road map for the unscrupulous and even comfort the observant to believe they are acting properly, if they are technically on side. Frequently, principles can be more effective than detailed rules, since they call for judgment, and most people do have a moral compass. On the other hand, certain detailed rules do mandate appropriate behavior, without being disruptive. The challenge, of course, is to decide which is which. Because this is a matter where market practitioners can bring their expertise to bear on policy, we have consulted with our members and are developing a set of recommendations for regulators and legislators.

In summary, we consider that CEO and CFO certification is important to investor confidence, yet not unduly expensive to comply with. Also, some public director participation is essential, but probably not to the level required by SOX. Also we support

the whistle-blower protections and additional financial penalties for improper disclosure of financial statements.

Let me turn now to what the IDA has done to address the issue of investor confidence. Both before and since Enron, we have taken a number of steps to bolster oversight, improve disclosure, toughen enforcement and enhance integrity in our capital markets.

One area that has faced tough scrutiny in recent months is research analysis. Analysts perform a crucial role in capital markets by interpreting and analyzing financial information and results and by valuing publicly traded companies. Investors have a right to know they can trust the motivation of the people they turn to for research analysis. They need to know that analysts are objectively assessing stocks, not touting them.

Although conflicts are not new, the relative increase in investment banking revenues has created a serious problem when firms act as underwriters and advisors to corporations that their research analysts cover. Existing rules and regulations, internal firm policies and provincial statutes are proving inadequate to deal with the problem.

We began to look at the independence of analyst research almost three years ago, when we established a joint committee with the Canadian stock exchanges. In June, our Board approved IDA Policy 11, which in some cases goes beyond the Committee's recommendations and will impose stringent requirements, very similar to those imposed by the New York Stock Exchange and the National Association of Securities Dealers, the self-regulatory organization for the US securities industry.

Our objective is to address investor confidence through the effective management of conflicts of interest. Our tough, practical and effective rules will prohibit activities that put investors at risk and require disclosure of information that investors need to make knowledgeable decisions.

We believe the public has a right and a need to know what shares a firm or analyst owns and any compensation practices that may influence an analyst's recommendations. Policy 11 will make sure that the public gets this information.

Among other highlights:

- Analysts will be prohibited from issuing reports when they are an officer, director or advisor to the issuer.
- Firms will be prohibited from compensating analysts directly based on a specific investment banking transaction and they must disclose whether the analyst received compensation based on general investment banking revenues in the past 12 months.
- Members will not be able to use favorable research ratings or price targets – or threaten to change their positions – as a means to gain business.
- Firms will be required to develop and enforce conflict of interest policies and procedures and file them with the IDA.

These new rules will set high standards, reduce conflicts, and bring consistent standards of conduct to our markets. We believe they will bolster investor confidence.

Another key ingredient of investor trust is robust enforcement. Investors have the right to expect that when someone violates the rules, he or she will be penalized. On that front, the IDA has also taken vigorous measures.

The best way to measure effectiveness is by results. Last year we assessed more than 1,000 complaints. In the first three quarters of this year, we imposed fines of over $4 million on firms and $1.3 million against individuals. We also suspended the licenses of three Member firms.

Nevertheless, the new environment requires more robust enforcement tools. That's why we are seeking additional powers. We need the ability to obtain investigation orders and compel witnesses to testify and produce documents at disciplinary hearings. And we need

the authority to file decisions of our disciplinary hearings as decisions of the court. This will allow us to collect fines from individuals who have left the industry.

The IDA role provides two fundamentally different streams or processes that a complaint can generate, each with its own objectives and results. I have been talking about the first process, which deals with a potential regulatory infraction and may result in an investigation, prosecution and penalty against a member firm or its employees. The objective is to afford justice, discourage future infractions and remove wrongdoers from operating in the market. However, like the securities commissions and the police, our disciplinary process does not provide restitution for the client. Since not everyone is aware of this fact, some people are surprised and disappointed that their central problem, financial loss, has not been addressed. Even those who do understand this limitation are still left with the problem of trying to get their money back.

We have therefore developed a second stream whose objective is to provide financial restitution through recommendations and binding awards. This process is also crucial to consumer protection and investor confidence. Simply put, investors who cannot resolve a financial dispute with their brokers need fair and effective ways to seek redress. I am very pleased to tell you that the IDA, in conjunction with the financial services industry, just launched a new consumer redress system. The Ombudsman for Banking Services and Investments is a consumer redress service that is independent, objective, accessible, timely and free. While its recommendations are not binding, the Ombudsman will publish the names of those firms that do not comply with OBSI's recommendations and a summary of these recommendations will be made public.

The IDA already offers Member firm clients a national arbitration system that is faster, less expensive, and less contentious than the courts. Like the Ombudsman service, it is mandatory for our members. Its recommendations are binding on both the client and the firm.

Bottom line, as we say in the securities business, clients of IDA member firms now benefit from the most comprehensive and robust consumer restitution system in Canada and perhaps the world.

These are steps that the IDA has taken to rebuild investor confidence. But we cannot do it alone.

Fortunately, there are other initiatives out there as well. The accounting profession, under fire about auditor independence and the integrity of financial statements, has recently established bodies to create standards and oversee their implementation.

In Ontario, a committee reviewing Ontario Securities legislation has generated recommendations to beef up enforcement, enhance shareholder rights, improve disclosure and become more responsive and timely when it comes to making rules. In B.C., the Securities Commission has undertaken an ambitious regulatory reform designed to reduce the burden of regulation, while ensuring investor protection through tough enforcement. And Québec is undertaking a fundamental restructuring of its financial services' regulations.

These are all important steps. But we need to go further. If our country is serious about ensuring a vibrant capital market and boosting investor confidence, then politicians must address a problem that no other country in the world has to confront - the lack of a single, national regulator for the securities industry.

The present system of 13 securities regulators is not efficient. There is no single voice for the country. Although attempts are being made to harmonize regulation across provincial boundaries, the process is long and arduous. In the meantime, duplication, inconsistent regulation and high costs undermine confidence and competitiveness.

Let me give you two specific examples of how we should do better, examples where everyone understands the potential for enormous improvement and yet, frustratingly, the will is lacking to take the necessary steps.

First: registration: An account executive should only have to register once to sell securities anywhere in Canada.

The reality? Although we are building an expensive National Registration Database to permit electronic, on-line registration, we do not have a single, uniform set of registration categories and professional standards. Each Commission continues to insist upon its particular requirements. Moreover, each application must still be scrutinized and approved by each Commission where registration is sought: in other words, multiple approvals. No one can seriously pretend that this mishmash contributes to investor protection.

Second: When a company raises capital, it should only have to file a prospectus once, in its own jurisdiction. A single approval should qualify the securities for sale in every other Province.

The reality: While part way there, we do not have a system of complete mutual reliance or fully harmonized regulations.

Canada's capital market, only 2% of the global market, needs to do better. The answer is either a national regulator or a completely harmonized system. The first alternative is in the hands of politicians. The latter can be achieved by the provincial securities commissions who are working together right now on a Uniform Securities Act. We heartily endorse that project and hope that all commissions can agree and that the necessary legislation will be passed in each province.

But we need to move quickly to ensure the national consistency that every other major market in the world takes for granted. I believe the burden is squarely on those opposing

a national commission, be it under Federal or provincial jurisdiction, to support decisive action to comprehensively harmonize the current system. They can discharge that burden, but it really is in the national interest to set the bar high.

There are some positive signs. I was encouraged that the Speech from the Throne signaled the Federal Government's intention to strengthen enforcement and work with all participants toward an efficient regulatory system. Recently, John Manley, the Minister of Finance, appointed Harold MacKay as his Special Representative to recommend a process to determine the best securities regulatory system for Canada's needs.

Provincial governments have a crucial role in this debate. They can legislate comprehensive uniformity of securities legislation in their jurisdictions. Alternatively, they can ensure that legitimate regional needs are taken into account in developing a national securities commission. What cannot be justified is opposition to a national commission from decision makers who are not willing to support substantive improvements in the present system, support in deeds, not just words. Interestingly, both sides of the debate should favour harmonization – on the grounds that it would represent an important step to a national commission or that it would make a national commission redundant.

One final point. Regulatory content should not be ignored while we reform regulatory structure. That means that everyone should join in the debate to assure we achieve an appropriate regulatory balance that addresses investor protection and allows our markets to grow and prosper, in the interests of all Canadians.

Restoring faith in our capital markets requires a coordinated contribution by provincial and federal governments, regulators, self-regulators and industry participants. We need a made-in-Canada solution aimed at market integrity, one that recognizes our role in a global market place and acknowledges the diversity of the Canadian economy.

Thank you and I look forward to your questions and comments.