SIPA
SMALL INVESTOR PROTECTION ASSOCIATION

April 30, 2004 sent by e-mail to jstevenson@osc.gov.on.ca

Mr. John Stevenson
Secretary
Ontario Securities Commission
20 Queen Street West, 19th Floor
Toronto, ON

Subject: The Fair Dealing Model
Concept Paper of the Ontario Securities Commission
January 2004

Dear Sir;

There should be no consideration of reducing regulation unless there is a concurrent introduction of investor protection by an independent authority that is not industry sponsored and is not staffed by industry personnel, and the introduction of TruthTeller legislation that will enable Canadians to come forward and tell the truth when they see wrongdoing without fear of reprisal.

Changes in rules and regulations are meaningless and will not have a beneficial effect for small investors unless there is strict enforcement and appropriate means for dispute resolution and payment of restitution in a timely and fair way. Regulators have been unwilling or unable to provide adequate investor protection. TruthTeller legislation would help the regulators by encouraging industry insiders to come forward.

History shows that self-regulation does not provide adequate investor protection. Industry practices that inevitably result in investor loss are not discouraged due to a failure to hold industry participants fully responsible for the impact on investors due to wrongdoing. There are many instances where individuals and firms have breached the rules and in some cases committed fraud, yet they were able to avoid any financial responsibility to the investors who lost their savings.

Marchment and Mackay were one of the penny stock dealers that caused investors to lose millions of dollars be selling them worthless penny stocks at inflated prices, and in some cases shares that were fraudulent, and yet there

was no criminal prosecution and the perpetrators were allowed to declare bankruptcy and retain their ill gotten gains.

An article in the New York Post January 25th, 2004 has captured the situation in the United States and this applies equally to Canada:

> 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.
> "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."
> Spitzer, 43, a graduate of Princeton University and Harvard Law School, where he was editor of the Law review, sees the solution in leadership.
> "I don't pretend to have any answers beyond the platitudinous observation that those who are in charge of the SROs have to be willing to rock the boat and have to *be willing to play the role of prosecutor or the system will fail," he said.*

Industry condoning unacceptable practices that generate earnings, and then jettisoning registered representatives who are caught and labeling them as "rogue brokers," indicates the urgent need for reformation. Revisions are required to protect not only investors but also registered representatives and ultimately the industry itself.

Widespread practices of wrongdoing in the investment industry, as well as corporate malpractices as revealed in the United States have already had an impact in Canada. When these same practices are revealed in Canada there will be additional impact. Investor and industry will suffer. Although advances in computer capability suggest that management and control could be more effective, it would appear that deterioration in ethics and morality is eroding any improvement that should have been provided with technological advancement.

The recent failure of Nortel executives to reveal the truth and the need for re-statement of earnings indicates that our regulatory controls are failing to provide investor protection. The extensive cover-up in industry could be mitigated with effective whistleblower legislation to enable those who would tell the truth to come forward without fear of reprisal. These TruthTellers would immeasurably help the Securities Administrators to do their job without additional expense. Already there are several situations where registered representatives have initiated civil actions against their firms alleging wrongdoing by the firm at great risk to their careers and financial well being.

There is growing evidence that some of Canada's leaders are aware of these problems and action is being taken to address these issues. However, it appears

that leaders are either failing to recognize, or reluctant to disclose the extent of damage being caused to small investors who lose their life savings due to widespread practices of industry wrongdoing.

The SIPA Report released in February this year should help some of the leaders with integrity to better understand the scope of this problem. Regulators and government have failed to act expeditiously even though learned minds have elaborately detailed the failures of the existing system, the need for reformation and proposed solutions.

Amongst other reviews and reports, the Stromberg reports in 1995 and 1998 and the Wise Persons Committee Report in December 2003 have clearly outlined the need for regulatory change. There is an urgent need for consumer/investor protection reform.

Meanwhile investors continue to suffer loss due to investment industry wrongdoing such as inappropriate investments, churning, inappropriate leveraging, unauthorized trading and undisclosed conflicts of interest. There is widespread failure to properly prepare KYC forms, and failure to follow the information in the forms. There is a failure of industry to properly supervise representatives and this conveys the impression that much of the wrongdoing is in fact condoned or even demanded by industry participants. The types of reports provided to investors often fail to properly inform the investor of the true state of affairs. In some cases a deliberate attempt to deceive could not be any more misleading.

We believe that the losses due to this type of wrongdoing are having a much greater impact on the lives of Canadians than many of the issues such as insider trading, and mutual fund manipulation that have an impact on all investors. Seldom do these other issues result in the total loss of an investor's life savings.

Small investors who suffer significant loss of their life savings due to industry wrongdoing soon learn that the regulators, except possibly in Quebec, will not help them get their money back. They also learn that industry sponsored dispute resolution mechanisms, such as the IDA arbitration program or the Ombudsman for Banking Services and Investments have limitations and proposed solutions often seem less than fair to the small investor. Indeed some of the opinions of these industry-sponsored agencies appear to be at variance with Supreme Court decisions regarding fiduciary duty of the investment industry.

Institutions and wealthy individuals are able to resolve their dispute by taking action and obtaining court decisions that tend to provide just resolution. However, small investors often do not have the resources (financial, physical & mental stamina, and time) to pursue legal action to a just resolution. Even when

they do pursue civil action as did Armand Laflamme, it hardly seems fair or just that it takes ten years and three levels of court to achieve a resolution.

It would seem that the leaders of the investment industry and the regulators themselves have little sense of morality, ethics and social responsibility. It is a great pity that Canada's Justice System has been reduced to "a game that lawyers play" and that those leaders who have a sense of integrity and honesty are unable to overcome those who are driven by selfishness and greed and an overpowering need to put profit above all else.

Justice John Morden, Ontario's former associate justice, was quoted in the Toronto Star on April 12, 2004, as saying:

> *"The corporations and the wealthy people can afford a lawyer and people below a certain level can qualify for legal aid. But there's a great tier of the population that can't afford a lawyer, so they either throw the towel in, which is very sad, if their rights are being infringed and not vindicated, or they're going to court on their own and the other side is represented by a lawyer."*

All too often small investors realize that they cannot afford to continue an action to obtain just resolution and therefore opt for an out of court settlement that is discounted from that which would seem fair.

Notwithstanding the WPC Report's recommendations for a Canada Securities Act and a Canadian Securities Commission, and although these recommendations are supported by many, it is improbable that this will come to pass in the near future.

The U.S. experience has shown that even the Securities and Exchange Commission, which has been perceived by many as superior to Canada's fractured regulatory system, failed to root out many of the problems endemic in the investment industry.

The New York Attorney General's Office with its Bureau of Investment Protection has identified and disclosed a number of issues that negatively impact investors. The major brokerages and the mutual fund industry have been charged with improprieties and have paid billions of dollars to settle. The identification of these issues was possible due to "whistleblowers" that receive protection, which encourages them to come forward and tell the truth without fear of reprisal.

As part of any revised regulatory system in Canada, legislation introduced recently to provide whistleblower protection for federal civil servants must be expanded to provide protection for all Canadians who are prepared to come forward and tell the truth about wrongdoing without fear of reprisal.

Most of the input for regulatory revision comes from the investment industry and those who provide services to the industry. It is time that the regulators confer with investors and those who are concerned with consumer protection and individual rights, and to seriously consider this input prior to proceeding with any proposed regulatory revisions that could reduce investor protection.

Any revisions should be accompanied by concurrent implementation of regulatory processes that would ensure that industry participants are monitored in such a way to ensure that rules and regulations are followed, failing which offending participants would be appropriately penalized and held accountable for restitution to each and every investor who suffers loss due to the wrongdoing and not just to those who are able to pursue a complaint.

Reliance upon industry sponsored agencies, agencies staffed by rotating industry personnel, or agencies without sufficient mandate to provide adequate investor protection and restitution will not improve the situation.

In general, the concept of clarifying the type of account offered to investors is worthwhile, and this has already been accomplished to some extent with the introduction of discount brokers. The qualifications for representatives to service these accounts must be clearly defined and rules must be stringently enforced to ensure representatives are properly qualified to provide Advisory or Managed-for-You services.

Types of products should be categorized for risk and investors must be advised of the types of risk they face with their investments as well as the specific level of risk for each product.

All documentation provided to small investors should be provided in clear language understood by average Canadians. Disclosure documents must indicate risk and investment costs and include imbedded compensation, restrictions on salespersons licensing, professional qualifications and their meaning, prior disciplinary actions for registered representatives and the firm (failure to supervise) and the level of risk associated with recommendations and how the recommendations fit the portfolio.

Where there is lack of language proficiency it must be incumbent on management to ensure that service is provided in a language understood by the investor.

Statements should be clear and concise and provided at a frequency appropriate for the type of investment and the investor but in no case less than quarterly. They should be provided in a timely fashion. There should be mandatory requirement s for information provided based upon type of account or type of product, but should include:

- Amount of cash paid in
- Amount of cash taken out
- Net amount of cash in
- Current Gross market value of account
- Amount of costs to cash out (redemption fees/commission)
- Current Net value of account
- Asset class breakdown – planned & actual
- Annualized rate of return
- Comparison with pre-agreed or external market indicators
- Each investment should indicate
    - Cost
    - Net market value
    - Annualized rate of return
    - Risk category
- Disclosure of risk types on each statement
- Earnings for company
    - Commissions paid
    - Trailer fees
    - Management fees
    - Margin interest
    - Other (spread, etc.)
- Comparison of earnings for company to investor earnings as % and $

While the Fair dealing Model is an interesting concept, implementation without concurrent provision for an independent investor protection authority and TruthTeller (or whistleblower) legislation will not help small investors and could be detrimental.

Nevertheless, comment is provided on some of the issues for your consideration.

Should representatives who do not meet investment counsel/portfolio manager requirement be allowed to form Managed-For-You relationships? (page 24)

Standards need to be established for all categories of service. Firms should be allowed to offer only those categories of service for which they have competent staff. Representatives who do not meet investment counsel/portfolio manager requirements should not be allowed to form Managed-For-You relationships

What is the best approach to address the problems regarding third party compensation? (page 41)

Small investors are often influenced to buy products based upon the reputation of the supplier and they also believe the supplier stands behind the product. Fund management companies who pay dealers to sell their products should be

held accountable for the actions of the dealers and sales representatives relative to their products.

Should the transaction summary be made mandatory, or should it remain a voluntary best practice? (page 59)

Regulations regarding the provision of information to investors should not be relaxed unless additional responsibility is placed upon the companies. Industry best practice has generally failed the small investor. The transaction summary should be made mandatory. History has proven that voluntary best practice is not an acceptable mode of operation in the financial services industry. This is an industry that has widespread practices that lead to investor devastation, yet these practices are condoned and sometimes demanded by industry.

Should some of the information in the Transaction Summary be optional? Are there circumstances where the risk level and the reason for the recommendation should not need to be disclosed? (page 59)

The Transaction Summary information should be mandatory for small investors. If there are circumstances or types of accounts or clients that would not require disclosure, this should be established at account opening and the type of transaction summary should be established at that time. Criteria should be established for determining when disclosure could be reduced, and this decision should remain with management and not the registered representative. In the case of smaller firms or individuals the disclosures should remain mandatory, unless approved by the regulator for each specific case.

Should the portion of the spread representing the rep's commission be split out? (page 65)

In all cases, investor's should be made aware of what the costs of investment are. Details should be provided so that investors know how much commission is paid and how much management charges are. Only then can investors hope to make intelligent choices. Disclosure should be mandatory.

Is it important to achieve risk measurement consistency across the industry? (page 68)

Investment risk is an involved subject and small investors often do not understand the different types of risk they face. Also the lack of standards makes it difficult for investor and representatives alike. There should be risk measurement consistency across the industry so that both investors and representatives will be in a position to make appropriate choices and decisions.

Should the formula for calculating returns be prescribed? (page 71)

The regulators should prescribe methods for calculating and reporting rates of return. Present practices vary from firm to firm and often tend to be misleading for investors. Annualized rates of return should be mandatory for each investment and for the account as a whole. Industry standardization would help investors and industry participants.

Should performance information be provided for each security or only for the overall portfolio? (page 71)

Investors should be provided with performance information on each security as well as the whole portfolio. This would help them to make or understand investment decisions made for their portfolio.

Should account statements be required to show returns on a dollar or percentage basis? (page 71)

Some investors may prefer dollars and some may prefer percentage. It should not be onerous to provide the information both in dollars and percentage and this should be mandatory.

Should returns be calculated on the basis of the past year, or since date of purchase? How difficult will it be to obtain book value information for each security? (page 71)

Investors need to know returns since the date of purchase, as this will affect the impact of taxation. They should also know the annual rate of return to assist with investment decisions. It should not be difficult to obtain book value if the system of reporting is mandatory and applied to all industry participants without exception.

Should we prescribe how frequently performance information should be provided to investors? (page 71)

Self-regulation and voluntary best practices has failed investors. Performance information should be provided with each report. The report frequency could depend upon the type of account, but should be provided quarterly at a minimum. Investors should be provided with an option for monthly statements if they are not automatically provided.

Should we require statements to include external benchmarks? (page 71)

Investors need to know how their investments are performing relative to other types of investments and the market generally. The inclusion of external benchmarks should be mandatory.

What kind of standards should we establish for external benchmarks? (page 71)

External benchmarks should include a rate of return for Canada Bonds, a rate of return for the TSE, and a rate of return for the Dow Jones as a minimum and these should be mandatory. Where investors invest in other types of securities appropriate benchmarks should be established.

How refined should risk categories be? Would high, medium, or low be sufficient? (page 76)

Standards need to be developed for risk categories for various products. Types of risk need to be defined and explained to investors in plain language.

How frequently should risk information be provided to investors? (page 76)

Risk information should be included in each statement with an overall assessment of portfolio risk.

Since inception the Small Investor Protection Association has been calling for better investor protection. SIPA has supported the call for a national securities regulator and believes there should be one central regulator to whom investors can turn to check out their financial advisor regardless of whether they work with insurance companies, banks, investment dealers, mutual fund dealers or mutual fund companies.

This one regulator should control a central registry for all sellers of financial products. At the same time there should be an authority that has a sole responsibility for investor protection but could work in conjunction with the central regulator. It should have the power to investigate and to order and pay restitution.

It is not acceptable for the Government to suggest that investors can rely upon civil litigation in the event of wrongdoing and criminal justice in the case of fraud. Small investors do not have the resources to pursue these courses of action.

Regulators may have dozens of staff with annual salaries equal to the life savings of some Canadians and be prepared to spend years arguing cases because they are well paid for their efforts, and the outcome does not materially affect their lifestyle. They probably cannot imagine the mental anguish of the small investor who has been victimized by the industry's often cavalier attitude towards the small investors life savings that results in significant loss.

When small investors approach industry or the regulators to have their complaints addressed it is often disillusioning when they encounter an industry attitude which suggests the investor should have been more knowledgeable and looked after their own interests. Are investors wrong to expect professional help from an industry that is supposed to have a fiduciary responsibility?

Although the investment industry has embarked on an investor education program it is premature to establish a regulatory regime that is based upon an educated investor. Indeed, many older investors are not computer literate and yet many industry recommendations appear to be based on computer use.

It would be absolutely wrong for regulators to relax regulations without concurrently establishing an appropriate level of investor protection that does not exist today.

Yours truly

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President