

October 1, 2014

Comments on the consultation draft of the Provincial Capital Markets Act (PCMA) and the consultation draft of the federal Capital Markets Stability Act (CMSA) <http://ccmr-ocrmc.ca/publications/> and

The Cooperative Capital Markets Regulatory System Governance and Legislative Framework

<http://www.fin.gov.on.ca/en/budget/ontariobudgets/2013/commentary.html>

ATTENTION: commentonlegislation@ccmr-ocrmc.ca

Kenmar Associates is pleased to respond to the Request for comments. We understand these comments will be considered in conjunction with the development of draft legislation for legislative approval.

By way of introduction, Kenmar Associates is an Ontario- based not-for-profit organization focused on retail investor education and protection via on-line research papers hosted at www.canadianfundwatch.com. Kenmar also publishes *the Fund OBSERVER* on a bi-weekly basis discussing investor protection issues primarily for retail investors. Kenmar routinely submit comments and ALERTS on proposed regulatory changes that could impact Main Street. Kenmar's no-cost Intervenor Service assists retail financial consumers with their complaints and restitution efforts.

The proposed regime

Our understanding is that the PCMA, will be proposed for enactment by each participating province and territory, addressing matters of provincial or territorial jurisdiction in the regulation of capital markets and would replace existing Securities Acts in each of the participating provinces. While the PCMA retains certain key components of current provincial securities legislation, it appears to introduce a number of new elements. Similar to current provincial securities legislation, it addresses requirements relating to recognized and designated entities, registration and prospectuses, continuous disclosure and proxy

information circulars' requirements and issuer bids. We cannot comment on the part of the PCMA which addresses trading in derivatives, as it depends on the yet to be proclaimed provisions from the Ontario *Securities Act*.

We are glad to see new provisions proposed with respect to a number of matters, including regulating market conduct through the introduction of whistle blowing provisions and prohibitions against benchmark manipulation. In effect, the PCMA accelerates the trend to delegate the development of securities legislation in the form of regulations to be enacted by the regulator as opposed to being contained in Securities Acts passed by provincial legislations. A provisions should be included for a mandatory 5 year review.

The complementary federal CMSA addresses systemic risk in national capital markets, national data collection and criminal law matters. While the criminal law provisions of the CMSA generally mirror existing *Criminal Code* offences relating to securities, the CMSA has created certain new criminal offences (including an offence for benchmark manipulation) and several provisions of the CMSA are drafted more broadly than the *Criminal Code*. This would seem to add to investor protection.

Definition of "Security"

With the shifting of market risk from intermediaries to end investors as corporations move away from defined benefit pension plans and other financial products. Products from the insurance industry like Segregated funds compete with mutual funds but are regulated differently and with a lighter touch. Accordingly, we urge the new enabling Acts to define a "Security "in such a way that regulatory arbitrage is constrained. Otherwise, most of the potential benefits will be lost as dual-licensed advisors shift assets to regulatory environments with the least compliance costs and risk of sanction.

Introduction

Given our limited resources, we have chosen to comment at a high level rather than a detailed review of all the documents. Our emphasis

is on retail investor protection. Given the breadth of the two significant pieces of legislation, one at the federal level with many novel provisions and one at the provincial level which will replace existing securities legislation and provide the legal framework for all securities regulation in the four provinces, and the potential impact on investors, a 60 day comment period appears to us to be a rather short timeline for thoughtful and informed commentary. Hopefully, competent responders will be able to meet the demanding Nov. 7 target date or obtain an extension if needed.

In preparing our response we have relied on previous research on a national regulator sponsored by the Federal Government, the *Financial Consumer Protection Good Practices* from the World Bank http://siteresources.worldbank.org/EXTFINANCIALSECTOR/Resources/282884-1339624653091/8703882-1339624678024/8703850-1340026711043/8710076-1340026729001/FinConsumerProtection_GoodPractices_FINAL.pdf and over a decade of experience dealing with retail investor issues.

The John Reynolds book *The Naked Investor* sounded a wake-up call for Canadian investors. Through real-life stories, it exposed the dark side of the investment industry, revealing the tactics of greedy brokers and advisors, voracious banks and mutual fund operators, and outright embezzlers. Some of the horror stories of financial assault are hard to read. Anyone reading this exposé would be hard pressed to credibly argue that the current fragmented regulatory regime is protecting investor nest eggs. Thus, a fresh approach to investor protection is welcomed by the investor advocacy community.

There is clearly a need for improvement in securities regulation in Canada and we welcome the Federal initiative. Utpal Bhattacharya, an associate professor of finance at the Kelley School of Business at Indiana University, crunched some numbers for the Task Force to Modernize Securities Legislation in Canada in 2006, and came back with some startling results. Comparing the OSC and the SEC's records between 1997 and 2005, he found that when scaled for size of the stock market, the SEC prosecutes 10 times more cases per firm for all securities laws violations and 20 times more insider trading violations than the OSC. Moreover, the SEC resolves cases faster than the OSC,

levying fines that are 17 times more per insider trading case than those of the OSC. Of course, without robust enforcement, all the Acts, Laws and regulations are of little value.

Advocates, like us, of the current system bemoan its poor protection of small investors, its inherent inefficiency in operating 13 bureaucracies across the country and its inability to respond rapidly to capital market events such as Ponzi schemes, defective products and systemic issues. It can also take years for different commissions to agree on necessary reforms and reciprocate each others' enforcement orders. To the extent the new approach will accelerate improvements, it is to that extent we support the changes.

The need to do it right

A few years ago a group representing the victims of convicted Ponzi scheme fraudster Earl Jones gave its "qualified" support to a national securities regulator. Here's a potent statement released by the Earl Jones Victims Organizing Committee:

"While our group has no interest being dragged into an ongoing political debate, the Earl Jones Organizing Committee agrees with the call for a Canadian securities regulator, and as such, we give qualified support to the federal government's recent proposal. A Canadian securities regulator holds the best potential to make a difference in preventing and deterring white collar crime. Criminals should not be able to exploit jurisdictional boundaries or inadequate resourcing and the government's latest efforts, if properly implemented, are an important step in cracking down on their activities. Without the proper mandate, operating practices, and strong national and provincial resources in place, however, a single regulatory body for Canada will be no more effective than the status quo; so for the sake of Canadian investors let's get this right."

Indeed, let's get this wonderful opportunity right. There can be no argument that the current system is dysfunctional and adversely affecting the savings and financial health of Canadians. Gaps need to be filled and weaknesses eliminated.

However, as we peruse the various documents provided we note a great deal of information on capital markets but relatively little on

investor protection per se. Canada needs a cooperative system that will strengthen investor protection , speed up required reforms , provide a fair dispute resolution /restitution system, and improve regulatory enforcement. Furthermore, the Capital Markets Regulatory Authority (CMRA) should enhance the oversight of systemic risk including systemic risks impacting financial consumers. This is key to providing a robust source of savings and retirement income for Canadians.

Need for enhanced Enforcement

According to the CSA 2012 Investor Index, the Key findings show that almost 30 %t of Canadians surveyed believe they have been approached with an investment fraud at some point in their life. Over half agreed they were just as likely to be a victim of investment fraud as anyone else. However, just 29 % of those who believe they have been approached with a fraudulent investment said they reported the most recent occurrence to the authorities. Given the deeper resources it is our hope that more effective and timely enforcement will result.

The fraud that occurs in the financial service industry is often more subtle than other forms of fraud. It usually arises from an abuse by an individual who is in a position of trust, such as a financial advisor or stock broker. While the advisor benefits, the investor's financial well being is affected. The advisor makes a recommendation that is not in the best interest of the client or is not explained to the investor. Too often it is recommended simply in order for the advisor to receive sales commissions. It is in this arena that the new Capital Markets Regulatory Authority (CMRA) can make the most difference for Main Street.

Independent Dispute resolution

Investors who experience large losses expect regulators will assist in recouping their losses, but what the victims find is that the process is complicated and very slow and inevitably the investor has little recourse. Those who have the money to pursue litigation get the service they need but the majority who do not must leave their concerns with the police, who are already overburdened and understaffed. Even when a crime has been committed, the Crown

often demands substantial evidence in order to pursue the case and legal fees are prohibitive. Any new system should provide a single point of entry for independent investment complaint resolution that is free, fair, timely and effective. We expect that OBSI will remain as the sole provider of independent complaint analysis and that its Terms of Reference will be reviewed in view of modern criteria for independent dispute resolution entities rather than financial services industry lobbying.

Improve Monitoring of the exempt market

We continue to sense that the exempt market is not as safe as needed for retail investors particularly in view of planned regulatory exemptions changes. A 2013 sweep of 45 EMD's revealed some shocking statistics: (1) EMDs selling securities to one or more clients that were non-accredited investors (without another exemption being available) (18% of EMDs reviewed), (2) inadequate suitability assessments due to over-concentration (i.e., investors investing a significant percentage of their portfolio in one security) (15%), (3) inadequate suitability assessments due to inadequate documentation on how suitability determination made (22%), (4) inadequate relationship disclosure information (45%), (5) no or inadequate policies and procedures (45%), and (6) inadequate processes for the collection, documentation and maintenance of KYC information (75%).

Compliance reviews carried out in the past year by the Ontario Securities Commission's (OSC) compliance and registrant regulation (CRR) branch resulted in more significant interventions, according to a new report.

OSC Staff Notice 33-745 – 2014 OSC Annual Summary Report for Dealers, Advisers and Investment Fund Managers indicates that 10% of reviews resulted in the imposition of terms and conditions on registration, up from 3% last year; 9% led to suspensions, compared with 4% in 2013; 5% went to enforcement, up from 2%; and, 3% ended in the surrender of registration, versus 1% the previous year. It notes that the regulator continues to "have significant concerns with EMDs that trade in, or recommend," related-party products; and, it is particularly concerned about firms that only deal in these kinds of products.

Among EMDs that only deal in related-party products, it says, "Significant deficiencies that we have continued to identify include misappropriation of investor funds; concealment of poor financial condition of related and/or connected issuer; sale of unsuitable, high-risk investments to investors; and high investment concentration in related party products." Another common deficiency, the report says, is that it continues to find firms that "do not maintain an adequate compliance system" and firms where top supervisors are not meeting their responsibilities.

If the CMRA is ready to step up to the plate, fine. Otherwise, it may be appropriate to establish a SRO for this segment of the market or have IIROC be the recognized SRO.

Other concerns

It is not clear what impact the new Capital Markets Regulatory Authority will have on retail investor protection. We generally support the establishment of a national securities regulator as long as investor protection is enhanced over what prevails today. We note with some concern that Directors all require capital markets expertise so retail investors are likely locked out. We strongly recommend some definitive representation from Main Street. Similarly, we are surprised there is no mention of Director gender diversity, a policy the OSC feels should be a factor in corporate board composition.

Our other immediate concerns include the following:

- How will investor protection priorities be set?
- What will become of the OSC's Office of the Investor?
- What is the role of OBSI and will the practice of approving consumer-unfriendly ECB's for banking complaints be discarded?
- Will existing National Instruments remain in force?
- Will the Capital Markets Regulatory Authority use the prevailing registration system NI31-103?
- Who will provide enforcement over inter-provincial systemic consumer issues?
- Will the OSC continue to oversee IIROC and the BCSC the MFDA?

- How will regulatory exemptions be assessed and applied across multiple provinces?
- Will an investor protection fund be established?
- How will Recognition orders work within the Capital Markets Regulatory Authority and with the residual CSA?
- What legislation will govern statutes of limitation?
- Will the new Capital Markets Regulatory Authority have an investor Advisory Panel and what will become of the existing OSC IAP?
- Will investor education initiatives continue to be funded and how?
- What will be the nature of the relationship with what remains of the CSA?

One immediate concern we have regards a regulatory exemption for Equity crowdfunding .Each province has set different rules, criteria and dollar limits. How would such an exemption be handled under the Cooperative Capital Markets Regulatory System Governance and Legislative Framework? Would there be a race to the bottom, would each participating province be free to go its own way or will the most robust provisions apply?

Advice must be regulated

A complete reform of the advice industry is required. Regulators have paid scant attention to the rapid growth of the asset management industry and its shifting away from a transaction-based model. The shift from sales to advice has occurred without corresponding changes in regulatory approach. We do not see any evidence that this disconnect is being effectively addressed in the new legislation. This is a once in a decade (or more) opportunity for reform that should not be missed.

Basing regulations upon the assumption that investors have the ability to look out for themselves, inherently means regulations are crafted for the smartest, most confident and experienced investors. This is wrong - regulators should look out for those most at risk of being taken advantage of. For this reason, a Best interests Standard coupled

with an enhanced proficiency standard should be the norm, not the exception for the rapidly growing wealth management industry.

Investor advocates have been pleading with regulators to regulate financial planners. Only Quebec has taken up the challenge. One of the potential benefits of the Cooperative Capital Markets Regulatory System is that it would create an opportunity to adopt unified standards and qualification requirements for financial planners, at least within the securities sector. The establishment of a CCMRS would allow for easier adoption nationally of a unified, single set of appropriate standards and requirements for individuals holding out to the public as financial planners, developed, defined and assessed by those expert in financial planning and in standards-setting and assessment of competence and ethics. This would increase investor protection for members of the public seeking the services of a financial planner, and limit individuals who have not demonstrated financial planning competence from marketing or promising these services (and offering unqualified or inappropriate planning advice) to unsuspecting consumers. We expect the CMRA to commit to making the regulation of planners a reality, realizing that the scope of their activities goes well beyond investments/securities.

Protection of Vulnerable investors

The rapid rise of the elderly and retirees (vulnerable investors) also necessitates a thoughtful strategic regulatory response but we do not see any specific provisions in the Consultation papers. **Canada is** on the verge of a "senior crisis" posed by the risk of seniors' outliving their assets and their declining ability to manage their money as they age. These are people who have been particularly impacted by substantial reductions in interest rates because the cash flow coming from their investments often is a significant supplement to whatever RRSP/RRIF, pensions and Social Security they have. Seniors are especially vulnerable to offers of yield-chasing, high-risk products and fraudsters. The increasing sophistication of financial products combined with longer life expectancy is creating an environment in which investor abuse and fraud can thrive. Please refer to *The Best Interest Standards and the Elderly* - Canadian MoneySaver

<http://www.canadianmoneysaver.ca/the-best-interest-standards-and-the-elderly/> for strong supporting arguments the need for enhanced investor protection for senior investors.

It is clearly not business as usual. More can and should be done to protect vulnerable investors. For example , it is wholly appropriate to adopt NASAA MODEL RULE ON THE USE OF SENIOR-SPECIFIC CERTIFICATIONS AND PROFESSIONAL DESIGNATIONS http://www.nasaa.org/wp-content/uploads/2011/07/3-Senior_Model_Rule_Adopted.pdf It will also be necessary to review Provincial and Federal privacy laws that restrict disclosure of client financial information to third parties, including securities regulators and other agencies.

We recommend the establishment of a seniors Directorate .It would serve as a coordinating functionary creating a working group consisting of representatives of the CMRA's Enforcement Branch, Compliance Inspections and Examinations Branch, and Office of Investor Education and Inquiries and representatives of the MFDA, IROC and others as appropriate. Such collaborative, integrated efforts are necessary to achieve the CMRA's mandate of protecting senior investors. The Directorate would also be responsible to develop effective senior outreach programs and launch a Senior Investor Resource Centre on its website to provide investor protection information to seniors. It may also be cost-effective to work closely with the FCAC on a number of financial consumer matters.

A Strategy to combat Fraud is required

A 2007 Canadian Securities Administrators Investor Study: *Understanding the Social Impact of Investment Fraud* estimates that over one million adult Canadians have been the victim of investment fraud and that half these victims were introduced to the fraud through an existing relationship of trust, such as a friend, family member or work colleague. The study shows it is a common occurrence in the lives of many Canadians, with almost one-in-20 having been victimized. Everyone is vulnerable and all investors can benefit by doing their homework

What is the impact of fraud? The study found the impact goes well beyond financial loss:

- The first and perhaps greatest casualty of fraud is trust. Not just trust in markets and investments, but trust in people in general.
- Experience with fraud also shakes the confidence of victims in the way markets are run.
- The next greatest casualty of fraud, particularly among victims with losses over \$10,000, is health.
- A second tier of health impacts relates to mental health.
- The third tier of health effects is more physical.
- The final casualty of fraud is social connections.

Since 2007, there are strong indicators that fraud has grown in level and scope.

FAIR Canada has just released a research report entitled "A Canadian Strategy to Combat Investment Fraud" with recommendations that could help blunt the growth of fraud in Canada. The report provides an overview of the types of securities fraud that affect retail investors and attempts to evaluate the Canadian system in place to protect investors from such fraud. FAIR Canada's report outlines nine recommendations to improve the system to better protect the Canadian investing public from investment fraud, including the need to: improve data collection; conduct more research; better coordinate amongst responsible organizations; identify emerging trends and key threats to investors; articulate clear enforcement priorities; assist victims in obtaining recourse; improve the registration check system; increase fraud detection (including the introduction of a whistleblower program); and launch an awareness campaign. The report also observes that there may be a nexus between the exempt market and fraud, and suggests this is an area that warrants further research. [FAIR Canada Makes Recommendations to Protect Canadians from Investment Fraud](#) We fully support their recommendations and urge the CMRA to commit to adopting these recommendations.

Summary and Conclusion

Kenmar Associates
Investor Education and Protection

These issues cannot be resolved by increased investor financial literacy. Likewise, better and more disclosure alone will not address the serious, systemic issues that have been identified –inadequate advisor proficiency, conflicted advice, lack of effective price competition and regulatory arbitrage.

We are emphasizing these priorities now, because if they are deferred it could take a decade or more before they are revisited again. This window of opportunity should not be missed.

As we have said many times before, we believe a securities regulator must encourage more investor engagement in its affairs. We encourage the new national regulator to invite ordinary Canadians on its Board and on key Committees and to establish a funded Investor Advisory Panel.

We hope these comments prove useful.

Permission is granted for public posting.

If there are any questions, please do not hesitate to contact me.

Yours truly,

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