FAIR

Canadian Foundation *for* Advancement *of* Investor Rights
Fondation canadienne *pour* l'avancement *des* droits *des* investisseurs

A REPORT ON

A DECADE OF FINANCIAL SCANDALS

FAIR Canada Calls for a National Action Plan to Tackle Investment Fraud

Executive Summary and Recommendations

February 2011

Executive Summary

Financial Fraud a Major Problem

1. For years, there has been a widely held belief that financial fraud is rampant in Canada. One in ten Canadians say that they have actually invested money in what turned out to be a fraudulent scheme. The number of fraud victims appears to be on the rise as does the amount invested.

2. FAIR Canada decided to study a select number of financial frauds to see if there were lessons to be learned about: (1) how to improve prevention, detection and prosecution of financial fraud and (2) how to better protect investors and compensate victims of fraud.

3. FAIR Canada limited its study to fifteen cases (most of which were high profile cases involving a significant amount of money and large number of victims) from across the country (including BC, Alberta, Ontario and Quebec). The review yielded some interesting and surprising results. However, the study was not a comprehensive empirical study of investment fraud in Canada. The findings should be seen in light of their being limited to these fifteen cases.

4. Preparing a report on combating investment fraud through better prevention, earlier detection and more effective prosecution and how to better compensate victims of investment fraud is an enormous undertaking requiring significant resources and access to information. FAIR Canada has limited resources and (although we have consulted with stakeholders) limited access to information. We welcome feedback from all stakeholders (and in particular, the governments, securities regulators, SROs, and others mentioned in this report), and may issue an amended version of this report with the benefit of such feedback.

Complex and Fragmented System Not Effective

5. The Canadian securities regulatory system is complex and fragmented. There are thirteen provincial and territorial securities regulators and two national SROs. In addition, there are many other provincial and federal regulators involved in regulating financial institutions and the financial products they sell. For example, insurance regulators regulate segregated funds, which are essentially a form of mutual fund with an insurance component added.

6. When it comes to the investigation and prosecution of financial fraud, the complexity and fragmentation of the system in Canada is far worse. In addition to the regulators listed above, local and provincial police, as well as the RCMP and IMET are involved in investigations. In addition, numerous provincial and territorial Attorneys General can be involved in prosecutions.

7. With this bewildering array of regulators, investigation agencies and prosecutors, no one agency has ultimate responsibility for combating investment fraud. If a victim of fraud

contacts the police or regulators, more often than not they will be referred to another agency.

Findings of Review of Cases

8. Findings from the fifteen cases reviewed by FAIR Canada included the following:
   - Approximately 78% of the losses in the fifteen cases involved firms or individuals registered with regulators.
   - Approximately 17% of the losses involved registered persons were with firms that were members of an SRO. Members of the two SROs are backed by compensation funds in the event of firm insolvency.
   - Some 61% of the losses were with registered firms directly regulated by a securities regulator but that were not members of an SRO. These firms are not backed by a compensation fund. Investors with non SRO registrants sustained higher losses and were not likely to recover most of their money.
   - Approximately 22% of the losses were a result of dealing with persons who were not registered with a securities regulator and investors often lost all of their money.
   - Even though there are two compensation funds (CIPF and IPF) that compensate investors in event of insolvency of investment firms and mutual fund dealers, the funds only compensated 2% of the financial losses because most of the investment scams involved firms that were not members of the compensation fund and related SRO and of the five that were, three fell outside the scope of coverage. The registrants that appear to be the highest risk to retail investors are not members of an SRO and have no compensation fund.

RECOMMENDATIONS

9. In summary, our recommendations address fraud prevention, early detection of fraud, enforcement and victim compensation:
   1. **Fraud prevention** – Government and regulators should launch a major campaign to educate consumers on avoiding financial fraud and securities regulators should provide a comprehensive national database to check registration, disciplinary history, SRO membership etc. We also suggest that: (a) firms be made responsible for misconduct by rogue advisors even when they sell non-firm products, (b) registrants have a professional duty to report misconduct by other registrants, and (c) financial incentives be considered to encourage reporting of fraud to regulators.

   2. **Earlier detection of fraud** – We recommend that regulators have dedicated resources to detect fraud. Regulators should reform "exempt offerings" and "accredited investor" exemptions in securities laws and should audit high-risk exempt offer filings.

   3. **Prosecution** – Canada needs a new expert national agency under the Attorney General of Canada dedicated to combating financial fraud.

4. **Compensation** – FAIR Canada recommends that all registrants that deal with the public be required to be members of an SRO with an existing compensation fund. Further, regulators should have consistent statutory powers to order compensation for victims of financial fraud and should have a clear mandate to seek compensation for victims of fraud.

Recommendations for Combating Financial Fraud and Compensating Victims

1. **Fraud Prevention**

   FAIR Canada recommends that:

   - Government, regulators and SROs launch a major public education campaign to educate Canadians about avoiding financial scams.
   - Regulators provide a comprehensive, plain language, "one stop" national system for the public to check registration status, background information (including proficiency and disciplinary record) and SRO membership for firms and individuals advisors.
   - Registered firms be made financially responsible for compensating clients that are victimized by a rogue advisor that they employ.
   - Regulators consider introducing rules that require all registrants to report potential serious misconduct by another registered person.
   - Financial incentives be considered for members of the public who report potential financial fraud (whether the potential fraudster is a registrant or not) to regulators or police.

2. **Earlier Detection of Financial Fraud**

   FAIR Canada recommends that:

   - Securities regulators devote dedicated resources to financial fraud detection and engage in more proactive measures to detect and prevent fraud.
   - Securities regulators reform the "exempt offerings" and "accredited investor" exemptions to ensure that they are not used to sell investments to unsophisticated consumers.
   - Regulators audit the veracity of exempt offering filings based on a risk assessment.

3. **Enforcement**

   FAIR Canada recommends that:

   - The Federal and Provincial Attorneys General, regulators and police convene a summit to discuss how Canada can do a better job of preventing, detecting and prosecuting investment fraud.

- The Federal Government consider the creation of a national agency under the Attorney General of Canada staffed by experts to specifically target investment and other financial fraud.

4. **Better Compensation for Victims**

FAIR Canada recommends that:

- Existing provincial regulators mandate that all registrants be members of an existing SRO backed by an existing compensation fund.

- Provincial regulators, SROs and compensation funds convene a summit to develop a strategy to ensure that compensation funds cover fraud leading to insolvency of all registrants, and to address gaps in compensation fund coverage.

- Securities regulators be given consistent statutory powers to order compensation for victims of financial scams, and a clear mandate to seek compensation for victims.