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RE: Notice and Request for Comment regarding compensation of consumers of financial products and services

Thank you for the opportunity to comment on the Notice and Request for Comment regarding compensation of consumers of financial products and services (the “Notice”) issued by the Autorité des marchés financiers (the “AMF”). FAIR Canada is pleased to offer comments to assist the AMF in assessing and developing the principles and objectives of the Financial Services Compensation Fund (the *Fonds d’indemnisation des services financiers* or the “Fund”) and in improving the effectiveness of the Fund for financial consumers.

FAIR Canada is a national, non-profit organization dedicated to putting investors first. As a voice of Canadian investors, FAIR Canada is committed to advocating for stronger investor protections in securities regulation. Visit www.faircanada.ca for more information.

FAIR Canada Comments and Recommendations – Executive Summary:

1. FAIR Canada welcomes the Notice and the opportunity to comment on consumer compensation, a topic that it views to be a cornerstone of investor protection. We recognize the important role that the Fund, and consumer compensation generally, play in protecting consumers and in strengthening the public's faith in the financial markets. We would like to commend the Québec government for mandating this public consultation on compensation for victims of financial crime. Our recommendations fall into three broad categories, outlined in sections 2 through 4.
2. Expand compensation fund coverage.
 - 2.1. FAIR Canada recommends that the compensation system for consumers of financial products and services be structured so as to cover losses due to firm insolvency and/or fraud. We suggest that the system be structured so that fidelity insurance provides compensation for victims of fraud and that SRO compensation funds cover losses resulting from insolvency. We recognize that requiring compensation funds to cover fraud can be onerous and therefore we suggest that fidelity insurance cover fraud and compensation funds provide another layer of protection focused on insolvency. The Fund could provide additional protection beyond that of fidelity insurance and compensation funds.

Require all registrant firms to be SRO members backed by an insolvency compensation fund

- 2.2. FAIR Canada considers it important to broaden compensation coverage for financial consumers to ensure that similarly situated consumers are provided with similar protection. FAIR Canada recommends that all registrant firms be required to be members of a compensation fund, either through membership in a self-regulatory organization (“SRO”) (which provides coverage under an existing compensation fund) or otherwise. The advantages of mandatory SRO membership would include the following:
- a) The risk of fraud leading to insolvency of registered firms could be reduced through closer oversight and supervision.
 - b) Investors would be compensated in the event of any registered firm’s insolvency.
 - c) Because SRO members are ultimately responsible for funding the existing compensation funds, all registered firms would have “skin in the game” since their members would, through assessments by the compensation fund, need to reimburse investors in the case of a firm insolvency. Greater incentives would exist for SRO members (i.e. all registered firms) to ensure that high standards of conduct were followed by all members of that compensation fund, to keep their premiums low.

Cover investment fund managers and portfolio managers

- 2.3. At a minimum, FAIR Canada supports the MFDA’s recommendation to require compensation fund participation for investment fund managers and portfolio managers. FAIR Canada recommends both insolvency and fraud coverage for both investment fund and portfolio managers.

Mandate fidelity insurance coverage for registered firms

- 2.4. We would suggest that the compensation system be augmented through the introduction of a requirement that firms obtain fidelity insurance coverage, which would provide insurance coverage for fraud and dishonest acts by their employees. Mandating fidelity insurance for firms would strengthen the protection of financial consumers in Québec and lessen the financial burden on the Fund.

Scope of registration should not affect compensation coverage

- 2.5. FAIR Canada does not believe that consumers should bear the onus of ensuring that the financial product they purchase falls within the parameters of the registrant’s authority in order for them to be compensated by the Fund. Investors should be covered where losses arise from fraud related to financial products sold by a registrant.

3. Educate consumers about the importance of dealing with registrants when purchasing financial products.

Public awareness must be heightened

- 3.1. FAIR Canada recommends that a major public education campaign be launched by government, securities regulators and industry organizations to educate Québécois, and all Canadians, about fraud prevention, including the importance of dealing with registered firms or individuals.

Comprehensive national registration verification system recommended

- 3.2. FAIR Canada urges Canadian securities regulators to develop a comprehensive, national

registration verification system to allow investors to check registration information. It should be simple, easy to use, and provide all the information investors need in order to protect themselves. The current system is simply too complicated for the average Canadian to use.

4. In addition to the two broad categories noted above, we also provide suggestions regarding: (a) improving recovery of compensation amounts, and (b) considering the introduction of professional liability insurance, which would cover fraudulent acts.

1. Introduction.

- 1.1. FAIR Canada welcomes this consultation as a means of identifying important principles and components of an effective consumer compensation system.
- 1.2. FAIR Canada considers it crucial that an appropriate balance be struck between protecting consumers from fraud and failures of registered intermediaries and, on the other hand, the need for an effectively and efficiently run safety net that is adequately funded.
- 1.3. Ultimately, FAIR Canada believes that the costs of a compensation fund, no matter how they are levied, will largely be passed on to the consumers of financial services. As noted by the AMF in the Notice, “[c]ompensation is therefore the last defence within a scheme to protect consumers of financial products and services.”¹ Although it is the last line of defence in the investor protection regime, compensation plays a crucial role in helping consumers recover from serious financial losses due to fraud or insolvency, and can help to repair their confidence in the capital markets.
- 1.4. FAIR Canada’s view is that combating financial fraud requires a multi-faceted approach; fraud prevention, earlier detection, and more effective prosecution, along with better mechanisms to compensate victims of fraud are all essential. It should be central to the AMF’s strategy in combating fraud and in its review of the compensation system to ensure that the design of the overall compensation system (of which the Fund is one part) reduces the likelihood of fraud occurring, to the greatest extent possible. FAIR Canada supports such an approach.
- 1.5. As we note below, existing gaps in compensation fund coverage need to be filled so that consumers who are exposed to similar risks are provided with similar protections.

2. Expand compensation fund coverage.

- 2.1. FAIR Canada recommends that the compensation system for consumers of financial products and services be structured so as to cover losses due to firm insolvency and/or fraud. We suggest that the system be structured so that fidelity insurance provides compensation for victims of fraud and SRO compensation funds cover losses resulting from insolvency. We recognize that requiring compensation funds to cover fraud can be onerous and therefore we suggest that fidelity insurance cover fraud and compensation funds provide another layer of protection focused on insolvency. The Fund could provide additional protection beyond that of fidelity insurance and compensation funds.

¹ Notice at page 1.

Require all registrant firms to be SRO members backed by an insolvency compensation fund

- 2.2. FAIR Canada considers it important to broaden compensation coverage for financial consumers to ensure that consumers exposed to similar risks are afforded similar protections.
- 2.3. Therefore, FAIR Canada recommends that all registrant firms be required to be members of an SRO backed by a compensation fund so that investors have recourse to a compensation fund where there is an insolvency of a registrant firm. The advantages of mandatory SRO membership would include the following:
 - a) The risk of fraud leading to insolvency of registered firms could be reduced through closer oversight and supervision.
 - b) Investors would be compensated in the event of any registered firm’s insolvency.
 - c) As SRO members are ultimately responsible for funding the existing compensation funds, all registered firms would have “skin in the game” since their members would, through assessments by the compensation fund, need to reimburse investors in the case of a firm insolvency. Greater incentives would exist for SRO members (i.e. all registered firms) to ensure that high standards of conduct were followed by all members of that SRO, to keep compensation fund premiums low.
- 2.4. FAIR Canada recommends that the AMF work with provincial regulators and governments to mandate that all registrant firms be required to become a member of an SRO (either existing or newly-created), backed by an insolvency-based compensation fund, within a reasonable amount of time. This would ensure the protection of investors by extension of compensation fund coverage.
- 2.5. The absence of coverage by the IPC in Québec is a gap that FAIR Canada encourages the AMF to address. Allowing the particular expertise of the IPC to deal with losses resulting from the insolvency of mutual fund dealers would ease some of the burden on the Fund. We encourage the AMF to explore the possibility of having a separate insolvency fund (either via the IPC or otherwise). For fraud, as we note below, we recommend that the AMF require firms to hold fidelity insurance which would compensate their clients in the event of fraudulent or dishonest acts committed by their employees.
- 2.6. In its submission to the AMF dated February 20, 2012, entitled “A Roadmap for Strengthening the Protection of Quebec Mutual Fund Investors”, Fraser Milner Casgrain LLP (“FMC”) also recommends that the AMF establish an insolvency scheme for mutual fund dealers in Québec, either through recognition of the MFDA as an SRO and the expansion of its coverage to Québec financial consumers or, alternatively, through the establishment of a Québec compensation fund for the mutual fund industry.²
- 2.7. FAIR Canada understands that it would be very problematic to expand compensation fund coverage to compensate investors who are defrauded by non-registered market intermediaries. That the Fund would not, as an example, compensate investors defrauded by Earl Jones (see the AMF’s *Reference Guide*³) is, in our view, unfortunate

² Fraser Milner Casgrain LLP’s submission to the AMF dated February 20, 2012 entitled “A Roadmap for Strengthening the Protection of Quebec Mutual Fund Dealers” at page 59 (“FMC Submission”).

³ Autorité des marchés financiers, “Reference Guide – Protection Mechanisms” (November 2011), at page 45, online: <http://www.lautorite.qc.ca/files//pdf/consultations/indemnisation/AMF-guide-ref_mecanisme-protection-an.pdf>.

but also realistic. Since the compensation funds are funded by dues paid directly by registrants (and therefore indirectly by the clients of registrants), the clients of non-registrants have no fair claim to compensation. Similarly, it is unrealistic to expect the government to create and fund a compensation fund to compensate consumers for financial fraud generally. Essential to the fair operation of this model is public awareness of the importance of registration, as discussed in sections 3.2 to 3.4. The system needs to be simple to navigate, comprehensive, and have a single point of contact for consumers to check registration.

- 2.8. In an ideal world, FAIR Canada would advocate for compensation for all true victims of financial fraud (as opposed to sophisticated investors who knowingly disregard clear and obvious signs of fraud in anticipation of compensation in any event). However, we recognize the practical limitations of compensation schemes, and, provided consumers are aware of the implications, believe that drawing the line at non-registrants is a balanced approach.

Cover investment fund managers and portfolio managers

- 2.9. FAIR Canada supports the MFDA's call for mandatory compensation fund participation for investment fund managers (to protect investors who hold their investment fund securities in client name at fund managers) and portfolio managers (to protect investors of portfolio managers).⁴ Such compensation fund "gaps" need to be addressed.
- 2.10. Three recent cases highlight the need for portfolio managers to be required to participate in compensation funds: Norshield Asset Management (Canada) Ltd., Portus Alternative Asset Management Inc. and Norbourg Asset Management Inc. These entities were registrants who were portfolio managers and also fund managers.
- 2.11. Furthermore, FAIR Canada's Financial Scandals Report⁵ found that, of the fifteen cases of financial fraud reviewed, 61 percent of the losses were with registered firms directly regulated by a securities regulator but that were not members of an SRO, and thus not covered by a compensation fund. FAIR Canada views the current compensation system to cover the lower-risk registrants, while there is an absence of coverage for those who deal with higher-risk registrants.
- 2.12. Canadian investors exposed to similar risks should be entitled to similar protection.⁶ Some companies are both fund managers and MFDA members. Consumers will not be able to recover if their assets are not held by the MFDA member but rather by the fund manager. Maintaining confidence in a system with such arbitrary distinctions is challenging and therefore we recommend that such compensation gaps be addressed.

Mandate fidelity insurance coverage for registrant firms

- 2.13. We recommend that the compensation system be augmented through the introduction of a requirement that firms obtain fidelity insurance coverage, which would provide insurance coverage for fraud and dishonest acts by their employees. Mandating fidelity insurance for firms would strengthen financial consumer protection in Québec and lessen the financial burden on the Fund.

⁴ Mutual Fund Dealers Association of Canada, "Regulatory Gap in Canada – Part II: Fund Managers: The Need for a Compensation Fund" (November 20, 2008), at page 4, online: <<http://www.mfda.ca/regulation/bulletins11/Bulletin0469-P.pdf>> ("Regulatory Gap Paper").

⁵ FAIR Canada, "A Report on A Decade of Financial Scandals" (February 2011), online: <http://faircanada.ca/wp-content/uploads/2011/01/Financial-scandals-paper-SW-711-pm_Final-0222.pdf>.

⁶ *Supra*, note 4 at page 5.

- 2.14. On the subject of fidelity insurance, FMC's submission recommends that fidelity insurance coverage be required for mutual fund dealers in Québec as it is required by National Instrument 31-103 for all registered mutual fund dealers across the rest of Canada.⁷ Fidelity insurance would require financial services firms to maintain insurance to cover fraud and dishonest acts by their employees (including registrant employees).
- 2.15. FMC's submission states:

We submit that the exception to this insurance coverage requirement for mutual fund dealers [in Québec] is not warranted. The absence of such an insurance coverage weakens considerably financial consumers protection in Quebec, denies the AMF of a useful ally in monitoring the financial integrity and business practices of the registered firms, renders more difficult the adoption of mechanisms which would strengthen the incentives of firms to assume their responsibilities concerning the enforcement of sound business conduct rules and practices within their firms and, needlessly increases the financial burden on the [Fund] and compliant members of the mutual funds industry.⁸

- 2.16. FAIR Canada concurs with the foregoing comments of FMC.

Scope of registration should not affect compensation coverage

- 2.17. FAIR Canada does not believe that consumers should bear the onus of ensuring that the financial product they purchase falls within the parameters of the registrant's authority in order to be compensated. Investors should be covered where losses arise out of fraud concerning financial products sold by a registrant, regardless of whether the registrant's registration category permitted them to sell that particular product.
- 2.18. FAIR Canada recommends that the AMF re-evaluate the Fund coverage condition that the fraud concern financial products that the representative or firm was authorized to offer under its AMF registration. Consumers may be capable of reviewing registration status (subject to it being made user friendly and comprehensive as discussed above and below) but are not necessarily capable of independently determining the authority of a registrant to sell a particular product to them. Placing the ultimate responsibility on consumers to identify whether the type of financial product being sold to them by a registrant is within that registrant's authority or not is unfair given the diversity and complexity of financial products and the similarity between financial products in today's financial marketplace.
- 2.19. FAIR Canada considers it sufficient to require only that the representative or firm was registered by the AMF. Financial consumers should not be required to ascertain whether the financial products being offered to them by the registrant are within the registrant's authority to sell. If a registrant commits fraud involving products which they are not permitted to sell under their registration, but which they nonetheless sell to their clients, the registrant and their firm should be held responsible and compensation by the Fund should be available to the consumer.

3. Educate consumers about the importance of dealing with registrants when purchasing financial products.

- 3.1. FAIR Canada considers there to be insufficient promotion of the fact that investing

⁷ *Supra*, note 2, at pages 46 and 54-56.

⁸ *Supra*, note 2, at page 54.

through non-registrants can increase the risk of fraud and financial crime, and disempowers investors to compensation. FAIR Canada encourages the AMF to take two crucial steps to regularize the investment process for consumers: (i) launch a public education campaign to emphasize the importance of dealing only with registered intermediaries and the importance of checking registrations before investing; and (ii) developing a comprehensive, national system for reviewing registration.

Public awareness must be heightened

- 3.2. FAIR Canada recommends that a major public education campaign be launched by government, securities regulators and industry organizations to educate Québécois, and all Canadians, about fraud prevention, including the importance of dealing with registered firms or individuals.
- 3.3. SROs and their member firms should also take on the responsibility of educating Québécois and all Canadians about the benefit of dealing with firms that are members of an SRO backed by a compensation fund.
- 3.4. FAIR Canada takes the view that consumers should be afforded an opportunity and provided with the tools to allow them to protect themselves from fraud. Currently, investors find it difficult to take even basic measures to protect themselves against fraud, due to the complexity of the registration system and the multitude of searches they must perform in order to complete a full background check.

Comprehensive national registration verification system recommended

- 3.5. The process of verifying that a potential adviser is registered is unnecessarily complex and confusing for retail investors. Frauds covered in the 2011 FAIR Canada Financial Scandals Report⁹ included scandals perpetrated against investors by firms and individuals with no registration whatsoever. A simple means of registration verification is a crucial element of a system that does not cover losses resulting from fraud perpetrated by non-registrants.
- 3.6. In order to protect investors from frauds and scams, securities regulators recommend that investors check whether a firm or individual is registered, and also verify the disciplinary history of individuals. Registration information for SRO and non-SRO firms and individuals is entered into a searchable national database, the National Registration Database (“NRD”) under the auspices of the umbrella organization that represents the provincial securities regulators, the Canadian Securities Administrators (“CSA”). Current information as to registration status, registration category, scope of activities and any terms and conditions can be searched for firms and individuals for all provinces except Québec and Ontario through the National Registration Search (“NRS”) provided on the CSA’s website, and a link to the Ontario Securities Commission’s registration database is provided. Québec registration information is available through the NRS, but additional information (such as terms and conditions) must be searched directly on the AMF website.
- 3.7. However, there are limitations for anyone unfamiliar with the technicalities of the registration system who tries to search the database. The investor needs to know the registered name of the firm, although this may not be the business name the investor knows. For example, a search for an adviser at “CIBC Wood Gundy” draws a blank. The investor needs to know to search “CIBC World Markets”. Investors may not understand

⁹ *Supra*, note 5.

the significance of a listed registration category (e.g. that “investment dealer” means an IIROC member) or what a condition attached to registration means. No registration history is shown for firms that merge or registrants that move from firm to firm. Disciplinary history is not shown on the national registration system. Information on disciplinary action is only available by searching SRO websites for SRO members, and for non-SRO members by wading through enforcement documents on individual regulators’ websites (although even this may not reveal disciplinary history).

- 3.8. The complexity of the regulatory regime and the fact that multiple sources must be consulted can make background checks, or even determining whether someone is registered or not, a difficult and confusing exercise for a retail investor. **Even when consumers are aware that they should “check” the registration information of a firm or individual, the system of registration currently in place in Canada is so complex that it would be difficult for most investors to understand exactly what and where they should check to get the basic information they need. It is not practical to ask the average retail investor to navigate through the complexities of the current system.**
- 3.9. To remedy this problem, FAIR Canada recommends that Canadian regulators provide an informative, comprehensive, “one-stop” national system for investors to check registration and background information (including proficiency and disciplinary history) and SRO membership for all firms registered with securities regulators and members of SROs, and to identify non-securities licenses for individuals licensed under different regimes with different sponsoring firms. This system should include plain language explanations of the information provided and be searchable under business names as well as proper legal names. Additionally, it should provide assistance to investors who do not have access to the internet and those who are not computer-savvy. There should be one phone number where a consumer can call to have the relevant information explained.

4. Other recommendations for improvement.

Improving recovery of compensation amounts

- 4.1. The *Reference Guide*¹⁰ notes that the Fund paid out nearly \$49 million in compensation between October 1, 1999 and March 31, 2011 and during this same period, recovered \$3 million or approximately 6% of the total compensation paid through subrogatory recourses. Clearly the recovery of amounts paid out in compensation needs improvement. We believe that this problem is similar to that of securities regulators’ challenges in collecting the fines that they impose against wrongdoers.¹¹
- 4.2. FAIR Canada recommends that securities regulators determine the extent to which this is due to a rational decision to not pursue collection (given the lack of any remaining assets in which to obtain recovery) or whether it is a result of other factors which are within their control, such as inadequate resources to devote to subrogatory recoveries,

¹⁰ *Supra*, note 3.

¹¹ See news release of the OSC issued on January 18, 2012 (online: <http://www.osc.gov.on.ca/en/Proceedings_sanctions-commission_index.htm>) and the ASC provided in its annual report (online: <<http://www.albertasecurities.com/news/ASC%20Publications/6116/2011%20ASC%20Annual%20Report.pdf>>) re ability to recover fine money. See also media articles at <http://www.calgaryherald.com/losing+millions/6031170/story.html#ixzz1k6uD8gkP> and <http://www.theglobeandmail.com/globe-investor/investment-ideas/streetwise/the-osc-is-clearly-no-collection-agency/article2308363/>.

lack of individual and institutional incentives to pursue subrogatory recoveries, or perceptions that such tasks are of a lesser priority.

- 4.3. A recent academic article has amassed evidence of massive government under-collection due to factors not beyond their control and has a number of recommendations that should be taken into consideration, such as: "...adding resources to collection efforts; locating collections responsibilities exclusively with in-house collections specialists rather than personnel with general enforcement duties; and restructuring collections-based incentives in various ways."¹²

Professional liability insurance

- 4.4. The need for the Fund is justified in part by the absence of fraud coverage under the professional liability insurance of registrants.¹³ However, FAIR Canada encourages the AMF to consider the possibility of requiring such coverage, as noted above during our discussion of fidelity insurance in sections 2.13 to 2.16. In the absence of fidelity insurance coverage, FAIR Canada encourages the AMF to consider requiring fraud coverage in professional liability insurance.
- 4.5. Such coverage is not implausible for professionals in the financial sector. FAIR Canada notes that, for example, the Insurance Councils in Manitoba and Saskatchewan require that persons licensed as insurance agents must carry professional insurance against fraud and dishonest acts, in addition to the existing coverage for errors and omissions.¹⁴
- 4.6. FAIR Canada believes that if professional liability insurance were required for registrants, and such insurance had a mandatory fraud component, registrants could have additional partners in the prevention of fraud and financial crime, in the form of professional liability insurers.

We thank you for the opportunity to provide our comments and views in this submission. We welcome its public posting and would be pleased to discuss this letter with you at your convenience. Feel free to contact Ermanno Pascutto at 416-214-3443 (ermanno.pascutto@faircanada.ca) or Ilana Singer at 416-214-3491 (ilana.singer@faircanada.ca).

Sincerely,



Canadian Foundation for Advancement of Investor Rights

¹² The Collection Gap: Underenforcement of Corporate and White-Collar Fines and Penalties, Ezra Ross and Martin Pritkin, Yale Law & Policy Review, Vol. 29, p. 452, 2011 at p. 507-508.

¹³ *Supra*, note 3, at pages 13 and 14.

¹⁴ For example, as part of the *Insurance Agents and Adjusters Regulation* passed April 11, 2011 Saskatchewan. See <http://www.insurancecouncils.sk.ca/download%20files/LICS%20Bylaws%20-%20current.pdf> Life Insurance Council By-laws, Schedule A, Part IV, Section 4.