SUBMISSION TO CSA ON THE PROPOSED SCOPE OF THE REVIEW OF SELF-REGULATORY ORGANIZATIONS

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

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FAIR Canada welcomes the CSA's review of the framework of the SROs and submits it should include a review of the fundamental approach to regulation of Canada's securities markets.

Executive summary

1. FAIR Canada proposes that the CSA's review should encompass a broader range of issues in light of public concerns about the role and effectiveness of the SROs.The authorities have not assessed Canada's SRO system for many years. The review presents an opportunity to undertake a comprehensive and broad-based review of the SRO system.

We believe it should cover all elements of the system, including:

- The rationale for using SROs and whether self-regulation is working in the public interest
- The scope of SRO regulation
- The SROs' corporate governance systems
- The SROs' mandates and responsiveness to the public interest
- The effectiveness of SROs in regulating markets and registrants, and protecting investors
- from abuses and unfair practices
- The CSA's oversight of the SRO

Introduction

2. **CSA Review of Self Regulation**
In December 2019 the Canadian Securities Administrators (CSA) announced that it will carry out a review of the regulatory framework of the self-regulatory organizations (SROs) that governs the regulatory mandates of IIROC and the MFDA. The CSA expects to publish a consultation paper by mid-2020 on issues raised in its review. The CSA said it will examine the reasoning that underpins the current regulatory framework for the two SROs ("the SROs") and how the framework has been working.

In-depth Review and Change Required

3. **FAIR Canada welcomes the CSA's review and submits it should include a review of the fundamental approach to regulation of Canada's securities markets.**

1. What is the appropriate amount of reliance on SROs?
2. How should the CSA address the inherent conflicts of interest between the SROs' mandates to regulate in the public interest and to promote investor protection while being effectively controlled by and responsive to the needs of their members, including both dealers and marketplaces?
3. Should the system continue to employ SROs at all, and if so, what responsibilities can they perform more effectively than the statutory regulators?

In this brief submission we set out the key issues that we propose be covered by the review and addressed in the CSA's upcoming consultation paper.

Rationale for Using SROs

4. **SROs in Canada play a significant role in the frontline regulation of equities markets, derivatives markets and related registrants, including investment dealers, mutual fund dealers and their registered persons** . Canada's securities regulatory structure is complex, with 13 statutory regulators and several SROs, including IIROC, the MFDA and the Bourse de Montréal. All of these regulators have responsibilities for regulating securities markets, investment firms, salespersons and investment advisors. In addition, recognized clearing and depository agencies[1] owned by the TMX Group of exchanges provide vital market infrastructure that plays a critical role in the Canadian financial system. Those exchanges and their clearing agencies are also licensed by CSA members and subject to ongoing CSA oversight. This complex regulatory structure is opaque and poorly understood by the public, and often within the securities industry itself.

Given the number of jurisdictions involved in securities regulation, the fact that SROs can operate on a national basis is important. But the multi-jurisdictional nature of SRO oversight limits the SROs' flexibility to implement decisions nationally to some degree. The review should consider how to minimize inefficiencies of that nature.

Is Self-Regulation Working in the Pubic Interest?

5. **FAIR Canada proposes that the CSA should consider whether self-regulation is working effectively in the public interest and in providing investor protections** . We believe that SROs' current practices in areas like corporate governance, transparency and enforcement raise important concerns. These concerns raise questions about the SROs' level of commitment to disciplining member firms and protecting investors and ensuring their rights are respected by dealers. If the regulatory system is to continue to rely on SROs, practices in those areas should be improved.

Further, the case needs to be made that SROs are able to carry out the regulatory responsibilities in question at least as effectively - if not more effectively - as the statutory regulators would be able to perform them.

6. If the investing public and other stakeholders would be better served by governmental authorities performing certain regulatory functions now carried out by the SROs, that approach should be considered. **What system will produce the highest levels of investor protection and confidence, which all agree is vital to healthy capital markets?** Whether SROs or statutory regulators incur the costs of performing regulatory functions should not be a major factor in this analysis since both are largely funded by fees imposed on the securities industry and on other participants like issuers.

7. **Reliance on self-regulation has been declining internationally for several decades now.** A wide range of regulatory structures exist in the world, and many still rely to some degree on securities exchanges, SROs and industry associations to perform certain regulatory or supervisory functions. Canada and the U.S. rely on self-regulation to a greater degree than any other country that we are aware of. There are historical and political reasons for that, as self-regulation has much deeper and more long-standing roots on this continent than elsewhere. To what degree should the Canadian securities regulation system continue to rely on self-regulation, a model that most jurisdictions have moved away from?

Overlapping Regulatory Jurisdiction

8. **As a result of the complex regulatory structure noted above, dealer firms of various types and their registrants are subject to different but largely similar rules, registration requirements, forms of supervision and compliance obligations.** They include both SRO members and dealers regulated directly by CSA members. Larger financial services companies that operate several types of dealers must deal with different rules and obligations for each of their sales channels. These varying but similar requirements lead to unnecessary complexity, duplication and inefficient regulation. They also make it difficult for any one regulatory agency to see the full picture of the investment industry and the risks that it poses. That is particularly true in Canada, with different provincial securities regulators and the fact that the banking system is regulated at the federal level.

Merger of the SROs

9. A merger of the SROs and extension of a new SRO's jurisdiction to cover firms and advisors now regulated by CSA members could produce benefits, especially for regulated firms. Regulatory efficiencies may also likely be realized, especially if CSA members transfer

jurisdiction over firms that they regulate directly now to a new merged SRO. We also believe that a single SRO with one set of rules and processes would make it easier for retail investors to understand the regulatory system, the standards that apply and their rights.

10. **However, FAIR Canada submits that merely merging the two SROs using the current self-regulatory model would not be adequate given the shortcomings of the current SRO system.** The result of a simple merger would be a stronger, more powerful SRO with an even bigger role in protecting investors. It will be critical for the CSA to ensure that a new SRO, if proposed, is an improvement on, not just an extension of, the current system. The CSA should also consider strengthening its oversight of the SROs, especially if a new, stronger SRO is proposed.

11. **The important question is would such a consolidation of jurisdiction over investment firms be in the best interests of the investing public? In considering a potential merger of the SROs, we urge the CSA's concept paper to raise a new self-regulatory model and SRO organization for discussion.** Rather than just integrating the IIROC and MFDA as they currently exist and rationalizing any differences, FAIR Canada believes that a new and different SRO based on updated principles and conditions of recognition by the CSA should be proposed. The new SRO model should take account of the issues listed below.

SROs Public Interest Mandate and Approach

12. **FAIR Canada proposes that as part of the CSA's review, the nature and meaning of the SROs' public interest responsibility, and how the CSA can ensure that it is met, be raised for discussion.**

13. The CSA has long taken the view that SROs have a responsibility to act in the public interest, which is reflected in their recognition orders. We believe that issues arise over how that responsibility is interpreted by the SROs and CSA members, and what it means. While the SROs boards of directors should determine that adoption of a rule or taking a new initiative is consistent with, or supportive of, their public interest responsibility, it is often unclear how or why that determination is made. The specifics of those determinations should be provided in each case and be included in the content of SROs' releases of new rules and policies for public comment.

Corporate Governance

14. **Strong independent SRO governance is obviously essential to deliver effective management and operation of an SRO, minimizing conflicts of interest, and earning the trust of investors.** It is clearly a basic pre-condition to continued reliance on self-regulation in Canada, especially if the CSA proposes to extend the jurisdiction of a new SRO.

15. **FAIR Canada has significant concerns about the governance of the SROs today.** There is a conspicuous absence of directors with experience in individual investors' concerns on the IIROC and MFDA boards of directors. **IIROC's board has tended to comprise mainly current and former securities industry members, as only a 2 year "cooling off period" is required before a former industry member qualifies for appointment as an independent director**. Recently, with the self-regulatory system facing increased scrutiny, IIROC announced plans to improve representation of directors with hands-on consumer and seniors' experience on its board of directors. This initiative is welcome, but with scarce details it remains to be seen whether this will translate into changes to the governance structure that provide genuine and significant investor representation or whether it is merely "greenwashing" ~ a measure announced at this time because of the CSA review. Therefore, we think the issue needs to be addressed in the CSA's review.

16. An example of an improved SRO governance structure could be a board of directors comprised of six directors who represent the interests of the SRO dealer members and marketplace members, and six directors who represent the interests of retail investors, institutional investors and individuals who have significant securities regulation experience and expertise.

17. **Further, beyond the board of directors, SROs' committee structures and district or regional councils wield considerable influence**. Specifics depend on the SRO, but generally they have important disciplinary and decision-making powers in areas such as registration. These bodies also form part of the consultative and decision-making process at the SROs, and so form part of the governance structure. Their roles and composition should also be addressed as part of the review of the SRO system, including the need for independent voices to be

present in the deliberations of those bodies.

18. **FAIR Canada submits that the rules and procedures on the composition of the boards of directors, committees and councils of the SROs should be considered in the CSA's review.** Further, the rules and procedures for nominating and electing or appointing directors and members of committees and councils should be reviewed.

19. **In addition, FAIR Canada believes that governance shortcomings are partly responsible for weaknesses in the SROs' enforcement programs and the degree to which senior management of the SROs is willing to act independently of its members and in the public interest**. A governance system that is responsive to the public interest and to the needs of individual investors would include strong independent directors who are willing to challenge the industry's view of issues and any perceived deference by management and the organization to the industry's views and interests.The nature and qualifications of independent directors, and the system for nominating and selecting candidates for independent director positions, should be addressed in the CSA's consultation paper.

20. **SROs' public consultation policies and processes should also be addressed.** The SROs have formal procedures for consulting with the public and stakeholders on their regulatory proposals, such as new rules, through a public notice and comment process. But the consultations are dominated by industry participants and it is difficult for organizations representing investors to respond effectively, let alone for individual investors and members of the public. Internal discussions and comment through committees, which are part of the SROs' policy and rule development processes are, by definition dominated by SRO members, as noted above. **We believe that the SROs should be required to engage proactively with investor groups, including FAIR Canada, to ensure they obtain balanced input and comment on regulatory issues and proposals.**

21. Over the past couple of years FAIR Canada has experienced resistance from IIROC in engaging in discussions and holding meetings to discuss regulatory policy issues that raise concerns for investor rights and investor protection. While in recent months this appears to be changing and there has been a renewed willingness to engage in discussions, the level of engagement that had previously existed has not been restored. We very much doubt that IIROC would refuse to meet with its dealer members.

22. Recently IIROC announced that it would form an "expert investor issues panel" to obtain feedback from people with experience in investor and consumer issues. It is seeking input on how the panel will operate. We believe this can be a sound initiative and plan to provide input to IIROC on the panel's role and processes. However, it remains to be seen whether IIROC will seek to genuinely consult with independent investor advocates and appoint experts who truly represent the interests of retail investors. Meanwhile, the SROs' regulatory policy consultation processes should still be covered by the CSA's review, in our opinion.

Compliance & Enforcement

23. The CSA's review should address the SROs' compliance and enforcement programs and consider how apparent weaknesses can be repaired in a new merged SRO.

24. We observe that IIROC and the MFDA rarely discipline investment firms or senior management in cases where investors suffer harm. They generally settle for a sanction against the salesperson even where it appears that the firm's policies or standards of supervision were in question. In such cases there is a lack of transparency in decisions, notices etc. on settlements about the potential culpability of the dealer member and its senior management, including whether issues such as the adequacy of supervision of salespersons were considered, and what the related findings were.

25. **Further, traditionally the SROs' enforcement actions have not considered potential compensation of investors harmed by misconduct**. They impose penalties intended to punish improper conduct and deter similar conduct, but financial penalties do not encompass disgorgement of profits from misconduct to clients who suffered damages as a result of the conduct, or compensation of such clients. Investors must rely on the complaints process, a flawed ombudsman process[2] for review of claims, or costly litigation (which is simply not accessible to most retail investors) to pursue compensation for losses caused by misconduct. Notices of disciplinary actions, decisions and settlements rarely state whether the firm has compensated investors who suffered harm.

26. There is a general lack of transparency and accountability inherent to the SROs enforcement hearing processes that provide for in camera hearings where proposed

settlements are presented to a hearing tribunal for approval without permitted access to the public. The hearing tribunal issues a written decision and provides limited reasons for the decision only after they have accepted and approved the settlement. **We believe that open court principles of law should apply to all SRO enforcement hearings including hearings to consider proposed settlements, to better ensure public accountability.**

27. **The use of funds raised by imposition of fines should also be reviewed.** Currently proceeds of fines are paid into a "restricted fund" that may be used for specific purposes under recognition orders, including investor education. In some cases, the funds appear to have been used for projects that arguably should be undertaken as part of SRO operations that are paid for by the SRO's securities industry members. IIROC has a formal policy that sets out the process for considering proposals for use of the restricted fund.**The CSA should ensure that fines collected as a result of disciplinary actions for misconduct impacting retail investors, do not end up subsidizing the securities industry firms, including the firms involved in the misconduct.**

CSA Oversight of SROs

28. **FAIR Canada suggest that the CSA's approach to oversight of the SROs should be included in the CSA's review of the SRO system in light of the need to ensure that shortcomings in the current system are addressed.** If a new merged, more powerful SRO is proposed that has expanded responsibilities, the specific needs to provide effective oversight of the new SRO should be considered. Many will have concerns about creating a larger, more powerful SRO that plays a bigger role in regulating the investment industry. That includes investor rights advocates such as FAIR Canada but may also include securities industry members and regulators themselves. **We believe such concerns have merit. The bigger the role an SRO plays in protecting investors and regulating the industry, the more important it becomes for the CSA to ensure that its oversight system is comprehensive and effective in ensuring that the new SRO is accountable and responsive to the public interest.**

29. CSA oversight of the SROs has expanded markedly over the last two decades or so. CSA members' regular oversight reviews of IIROC and the MFDA are thorough and cover the key elements and processes of their self-regulatory programs. The CSA alsocarries out very detailed reviews of proposed changes in SROs' rules, which can result in significant delays in implementation of new rules. However, based on CSA members' releases about their oversight reviews of the SROs, it appears that they focus primarily on technical issues with specific regulatory programs and whether the SRO is meeting the conditions set out in its recognition orders. **FAIR Canada believes that oversight reviews should focus to a greater degree on broader structural issues like the effectiveness of corporate governance, the level of transparency provided by the SRO, and achievement of major objectives such as serving the public interest and ensuring that investors' rights are protected**. We suggest that the CSA consider expanding oversight reviews of the quality of governance and management of SRO operations, and the resulting effectiveness of the regulatory programs that boards and management oversee and administer. **The CSA oversight process should be focused on achievements of identified, high-level overall outcomes that serve the public interest and address the SRO responsibility for investor protection, rather than mainly on the thoroughness of SRO internal processes.**

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1 The Canadian Depository for Securities (CDS) and the Canadian Derivatives Clearing Corporation (CDCC)
2 MFDA and IIROC dealers must become members of the Ombudsman for Banking Services and Investments (OBSI), which offers an independent dispute resolution service for investors. Although the CSA requires registered firms to offer OBSI's services to clients with certain types of disputes with a firm, OBSI's decisions are not binding on the firms.

About FAIR Canada

FAIR Canada is a national, independent charitable organization dedicated to being a catalyst

for the advancement of the rights of investors and financial consumers in Canada. As the voice of the Canadian investor and financial consumer, FAIR Canada advances its mission through outreach and education, public policy submissions to government and regulators, proactive identification of emerging issues and other initiatives. FAIR has a reputation for independence, thought leadership in public policy and moving the needle in the interests of retail investors and financial consumers.

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