A PRACTICAL APPROACH TO ENHANCE THE PROTECTION OF QUEBEC MUTUAL FUND INVESTORS

20 February 2012

The Quebec government has mandated the Autorité des marchés financiers (''AMF'') to hold a public consultation on compensation for victims of financial fraud. In response, the AMF published, on December 9th, 2011, a Notice of consultation on the compensation of consumers of financial products and services in Quebec (''financial consumers'')[1]. The mutual funds sector is the main concern because of its large size, Quebec customers of mutual fund dealers are not covered by a Canada wide compensation scheme and the industry has been the locus of major frauds in the recent past.

It is generally accepted that the first recourse of a customer who has been deprived of his financial assets because of the incompetence or malevolent actions of an employee should be to that customer's financial firm. To ensure added protection in cases where compensation by the firm of the losses incurred by victims of errors, omissions **and fraud** would jeopardize the financial integrity of the firm, all leading European and North American jurisdictions require that securities and mutual fund dealers maintain fidelity insurance coverage and, as a means of last resort, have mandated the establishment of an industry investor compensation scheme to cover losses stemming from the bankruptcy of a financial services firm, whatever the cause. In North America, the surveillance and audits of the firms to ensure they comply with prudential and business conduct rules is carried-out by self-regulatory organizations (''SRO'') under the oversight of a public regulatory agency. This arrangement is coherent with the fact that the financial risks of the investor compensation schemes is borne by industry, not taxpayers. It also helps shield the public regulator from the pressure of demands and judicial actions prompted by the pervasive role of the State in regulating the financial sector and its vulnerability to concerted ''political'' action which, too often, are not imbued by concerns for fair and equitable treatment of all injured financial consumers.

Quebec has, heretofore, adopted a singularly different approach for mutual fund dealers:

- In Quebec, regulations require registered representatives to maintain **professional liability insurance** whereas, in accordance with National Instrument 31-103, all mutual fund dealers in the rest of Canada must maintain **fidelity insurance.**

- The role of the Chambre de la sécurité financière (''CSF''), the SRO recognized by the AMF, is limited to monitoring the practices, maintaining discipline and overseeing the training and ethics of mutual fund representatives. The critical dimensions related to compliance with capital adequacy rules and business conduct requirements for the firms remain under the direct purview of the AMF.

[1] Notice and Request for Comment regarding compensation of consumers of financial productions and services – Autorité des marchés financiers (AMF), December 9, 2011

Reference Guide – Protection Mechanisms, Consultation on compensation of Québec consumers of financial productions and services, Autorité des marchés financiers (AMF), November 2011

- The Fonds d'indemnisation des services financiers (''FISF'') compensates financial consumers for the dissipation of financial assets caused by fraud whether or not the registered dealer or representative is insolvent. It is part of and managed directly by the AMF. It does not compensate financial consumers in the case of failure of a registered mutual fund dealer unless it results from a fraud committed against Quebec financial consumers. In contrast, investor compensation schemes in the European Union and North America, including the MFDA Investor Protection Corporation (''IPC''), are insolvency schemes. They provide protection against the risk that a financial services firm may not be able to return to investors the cash and financial assets belonging to them in the event of bankruptcy, for whatever cause, including when its demise is due to fraud.

- FISF is not recognized as a **customer compensation body** under the *Bankruptcy and Insolvency Act* whereas the Canadian Investor Protection Fund (''CIPF'') and the IPC are recognized under the Act. Consequently, the AMF and, hence, Quebec financial consumers, are at a distinct disadvantage in bankruptcy proceedings, particularly if the bankrupt firm was domiciled in another province.

The level of protection provided to Quebec mutual fund investors should not be inferior to the protection bestowed to financial consumers in other Canadian jurisdictions. Therefore, a comprehensive review of the Quebec approach to the compensation of financial consumers of mutual funds harmed by unethical dealings, false or misleading representations, misappropriation of assets, unlawful conduct and fraud or the bankruptcy of a financial services firm must take full account of the regulatory regimes and approaches prevalent in other jurisdictions, the interplay of investor compensation schemes with bankruptcy and insolvency laws and the experience and lessons learned by other major regulatory agencies in dealing with such situations.

I. The Genesis of the Quebec approach with regards to mutual fund dealers

The rationale that underpins the current approach vis-à-vis mutual fund dealers stems from a view of the evolution of the structure of the Quebec financial industry that no longer forms the basis of the policies pursued by the Quebec government in this area. It is useful to retrace its genesis and contrast the present reality with the underlying assumptions held at the time.

Ever since the publication in 1962 of the ''Parizeau Report'' on the regulation of the financial sector in Quebec, the policy direction has been to promote the elimination of the barriers between the different segments of the industry. In order to maximize the economic benefits of the ''décloisonnement'', Quebec adopted the *Market Intermediaries Act* in 1989, superseded by the *Financial Services and Products Distribution Act* (the ''FSPD Act'') in 1999. This Act lifted the barriers to the establishment of multi-sector distribution firms for financial products and services, including insurance based saving and mutual fund products (through ''cabinets''). The oversight of the mutual fund dealers was transferred from the Quebec Securities Commission to a newly created entity, the Bureau des services financiers (''BSF''). The assumption was that the regulations for the distribution of securities and insurance products would be merged into a single regime. It is in this context that the Fonds d'indemnisation des services financiers was created. The FSPD Act established a whole new compensation scheme distinct from the Canadian Investor Protection Fund (''CIPF'') which is compulsory for securities firms.

The main features of this regulatory apparatus were heavily borrowed from the measures adopted by the accountant, notary and lawyer professional orders in Québec: a mandatory requirement to maintain professional liability insurance and the establishment of a contingency fund to protect clients who have deposited moneys that the professionals must hold in trust until a transaction is completed. Accordingly, the organizing principles of the approach are centered around the registered representative as an individual professional at the exclusion - almost - of the corporation which is their employer or for which they work as agents.

Implementation of these measures created problems of its own that were documented in the ''Martineau Report'' of 2001. The Report recommended a wholesome reform anchored on an integrated regulator, the AMF. The policy thrust to consolidate the regulations concerning the distribution of financial products in Quebec was reasserted. Not much was said at the time about the relevance, design and scope of coverage of the then existing compensation schemes, except a broad recommendation to merge all of them into a single ''patrimoine d'affectation'' under the direct management of the AMF. In 2002, the integrated vision proposed by the Martineau Report was incorporated in the legislation that created the AMF.

This integrated vision was soon to be cast aside to pursue the pan-Canadian securities regulatory initiative put forward in September 2004 by the Council of Ministers responsible for securities regulation. This initiative was aimed at adopting a highly harmonized securities regulatory framework across Canada that would allow a passport regime to be put in place

In 2009, Quebec took the first step in unravelling the intellectual construct that informs the current approach by reintegrating the mutual fund and investment contract segments of the FSPD Act into the *Quebec Securities Act*. For all practical purposes, the passport regime is now implemented and regulations pertaining to mutual funds are harmonized across Canada, save for the regulatory oversight arrangement, the insurance requirements and the investor compensation scheme in Quebec.

The Quebec mutual fund industry is not a cottage industry. As of September 30th, 2011, the value of the financial assets held by Quebecers in mutual funds amounted to $110.3 billion of which 45.6% were held in the custody of deposit taking institutions. In fact, about 63% of the AMF registered representatives are in the employ of Quebec-based MFDA member mutual fund dealers and 33.5% of other MFDA member mutual fund dealers active in the Province. Moreover, about 90% of the representatives in Quebec are employed by or agents of large financial institutions or corporations.

Quebec mutual fund investors are ill-served by a representative-centric regime while the reality is that they are the customers of the firm, as is the case for securities dealers. The insurance coverage requirements and the design of the investor compensation scheme for mutual fund dealers should be in synch with this reality, not remain stuck in a distant vision.

<u>II. Insurance coverage requirements</u>

In Quebec, mutual fund dealers must ensure that all their representatives, whether employees or not, are covered by professional liability insurance. Professional liability insurance grants to insured (representatives of firms) coverage against the monetary consequences of their civil liability in case of professional errors, fault, negligence, or omissions committed in the pursuit of their activities. According to the AMF, this insurance protects clients from possible monetary consequences sustained as a result of professional errors, fault, negligence, or omissions, and thus protects the insured against risks of insolvency resulting from a claim.

Professional liability insurance does not cover fraud, embezzlement or other scams to steal money or assets from financial consumers. The value of the stolen assets can be quite significant. The first rule of prudential regulation is to protect the capital adequacy of the registered firm. This AMF mandatory insurance requirement does not meet the test, the more so since the net cost of fraud is often substantial. The data from the SIPC is revealing: fraud was the cause for about 55% of the firms they had to liquidate; these liquidations account for over 81% of the total cost incurred by SIPC for all the cases it had to resolve. **The point is not that the coverage of professional liability insurance is not important; it is simply that it does not cover losses stemming from fraud or other unlawful actions. As a rule, financial services firms in Canada maintain fidelity insurance that covers fraud and dishonest acts by employees in addition to insurance coverage for ''errors and omissions''.** The assertion repeatedly made in the AMF Reference Guide for the consultation that ''professional liability insurance does not cover fraud'' is valid; however, this is patently not the case for the misappropriation of client assets or fraud committed by an employee or an agent of a firm covered by fidelity insurance.

There exists no valid reason not to require all Quebec mutual fund dealers to maintain fidelity insurance coverage as a condition of registration. NI 31-103 imposes on registered mutual fund dealers across Canada, except in Quebec, the obligation to maintain such insurance coverage. Annex A to the National Instrument is not ambiguous as to its intent and purpose: ''This clause insures against any loss through dishonest or fraudulent act of employees''. The AMF accepts as much in the case of securities dealers which are required to maintain bonding insurance. Why should this effective protection mechanism (or equivalent fidelity insurance protection) not be adopted for mutual fund dealers in Quebec?

The AMF regulations which require mutual fund dealer representatives to carry professional liability insurance in lieu of fidelity insurance by the dealer are in several ways ineffective as a consumer protection mechanism, if not outright counterproductive. Since theft, embezzlement and other fraudulent misappropriation of assets constitute one of the major causes of financial injuries to financial consumers, the absence of insurance coverage for such events leads inexorably to the need to adopt another means to indemnify financial consumers against fraud committed by representatives or other employees of a mutual fund dealer. Hence, the creation and singular mandate of the Fonds d'indemnisation des services financiers (''FISF'').

III. Current investor compensation fund coverage

Financial consumers of mutual funds which are clients of an investment dealer in Canada are covered by CIPF. Since the Investment Industry Regulatory Organization of Canada (''IIROC'') is recognized as an SRO by the AMF, Quebec financial consumers enjoy the same protection as all other Canadians in the event of failure of ''their'' securities dealer whether as a consequence of fraud or any other cause. In such circumstances, securities and certain other assets received, acquired or held by the securities dealer in a client account at the dealer, are covered for losses up to $1 million for the general account and $1 million for separate retirement accounts. Each category of account is eligible for the full coverage. Financial consumers of mutual funds which are client of a mutual fund dealer are covered by FISF, if domiciled in Quebec, and by IPC if located elsewhere in Canada. The coverage provided by each of those investor protection schemes differs significantly.

3.1 The Fonds d'indemnisation des services financiers

The FISF was established in 1999 pursuant to the *Act Respecting the Distribution of Financial Products and Services* (''DFPS Act''). Since 2004, it has been merged within the AMF. Even though its assets are kept separate from other AMF assets, the FISF is not a distinct corporate entity. In 2005, three former industry sponsored compensation schemes, the Fonds d'indemnisation en assurance de personnes, the Fonds d'indemnisation en assurance de dommages and the Fonds d'indemnisation des planificateurs financiers, were merged into the FISF.

The maximum compensation payable by the FISF is $200,000 per claim. The AMF bears the costs of the legal action initiated to obtain a receivership order. However, the receiver's fees and expenses are paid out from the assets under administration, hence, by the financial consumers and not directly by FISF as is the case with the US Securities Investor Protection Corporation (''SIPC'').

The FISF coverage policy excludes from compensation losses arising from a fraud:

- committed by a registered person or organization which is not in the categories included for coverage by the Fund (i.e. securities broker-dealers and fund managers);[2]

- committed by a registered person or organization covered by the Fund with respect to activities in breach of any limitation on its authorization or lacking such authorization;

- undertaken by an individual or organization that is not a registered representative of a covered firm.

The eligibility conditions of the scheme make it very difficult for any communications program to explain the ''ins and outs'' of the FISF scheme to financial consumers in an effective manner. The AMF recognizes this problem: ''The scope of current coverage under the Compensation Fund is

[2] The categories included for coverage are the registered market intermediaries which carry activities in the following segments: insurance of persons, group insurance of persons, damage insurance, claims adjustment, financial planning, mutual fund brokerage, scholarship plan brokerage.

limited and misunderstood, since it varies depending on the intermediary's registration category and the product offered.''[3]

Despite the fact that FISF's coverage policy excludes non registered entities or representatives, the Courts have ruled that due account must be given to the formal and informal connections linking entities of a same group involved in a financial fraud and, therefore, that injured financial consumers are entitled to the insurance coverage whether or not the fraud originated directly from a registered or non registered member of the group[4]. In essence, substance must prevail over form. This Court ruling is in line with existing U.S. jurisprudence and to the same effect as the European Commission Directive on investor compensation schemes adopted by the European Parliament on 5 July 2011.

FISF excludes from coverage losses resulting from the bankruptcy of a financial firm that is not caused by fraud. Since MFDA is not recognized as a self-regulatory organization in Quebec, assessments for the MFDA Fund are not levied in respect of assets under administration of MFDA members in Quebec and their Quebec customers are not entitled to the protection of IPC should a MFDA member fail for any reason. Thus, in the event a mutual fund dealer fails for any reason other than because of fraudulent actions against Quebec financial consumers, it is highly problematic whether losses incurred by Quebec financial consumers would be eligible for compensation by any present investor compensation scheme.

The primary source of funding of FISF is an annual assessment of the representatives covered by the scheme. In contrast to other investor compensation schemes, FISF is not capitalized. Since 2003-2004, FISF has been in a deficit position whereas the IPC investor protection fund has about $30 million in capital.

3.2 The MFDA Investor Protection Corporation

IPC is a not-for-profit corporation established in July 2005 by the Mutual Fund Dealers Association of Canada (''MFDA''). All registered mutual fund dealer firms across Canada are required to be members of IPC, except in Quebec. As of June 30, 2011, thirteen MFDA member firms had their head office in Quebec. The assets under administration held by these Quebec based firms amounted to $11.9 billion.

The purpose of IPC is to administer an investor protection fund (''MFDA Fund'') for the benefit of clients of mutual fund dealers that are members of the MFDA in the event that a member firm is liquidated or becomes insolvent, whatever the cause. To benefit from IPC coverage, financial customers must hold an account with an MFDA member for the sole purpose of transacting securities business directly with the member. Financial institutions and firms and related parties to a member are excluded from coverage.

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[3] AMF – ''Reference Guide : Protection Mechanisms'', november 2011, p.65

[4] 3677842 Canada Inc. v. Autorité des marchés financiers à titre d'administrateur et gestionnaire du Fonds d'indemnisation des services financiers (2010 QCCS 5306(CANIII). Justice Godbout states that « étant donné que M. Lacroix était directement ou indirectement actionnaire de tous ces intervenants, chacun doit être considéré responsable de la fraude » (par. 182)… « ce détournement de fonds est l'objectif ultime d'une démarche plus vaste, soit la mise en situation de plusieurs intervenants qui, accomplissent leurs fonctions usuelles, et qui sont parties à une fraude. » (par. 195).

For the purpose of determining IPC payment, customer accounts are grouped in two categories, general and separate accounts. The maximum amount of coverage for eligible financial assets is $1,000,000 for each category of account, subject to the aggregation of accounts within a category and net of any other compensation related to the loss. **This coverage is similar to that provided by CIPF**.

Eligible financial assets are restricted to securities, cash, segregated funds or other property in which an MFDA member is entitled to deal pursuant to this registration as a dealer under applicable legislation. Property that is held, or should have been held, by an MFDA member for the account of a customer at the effective date of insolvency and which the insolvent member is obligated to return to the customer is also covered.

The IPC coverage policy states that the following financial assets are not covered:

- Accounts with entities other than a MFDA member, including a member's affiliates or related organisation.

- Financial assets that are not held by a MFDA member, or not recorded in a customer's account as being held by a member, such as mutual fund securities that are registered directly in the name of the financial customer with a mutual fund company or deposits with financial institutions, even though they were sold through the member to the customer, unless they are otherwise in the custody or control of the member. Such custody or control may arise where a member or its representatives have ostensible control over assets of a customer holding client name financial assets by virtue of a power of attorney, trading authorization or temporary receipt of cash intended to be received by a mutual fund company or other issuer.

- Accounts held with MFDA members by financial customers domiciled in Quebec. Generally, for eligibility purposes, an account is considered to be owned by a Quebec resident if the office serving the customer is located in Quebec.

The timing of payments to injured customers is left at the discretion of the IPC Board of Directors.

The MFDA Fund is funded through the levy of quarterly assessments on MFDA member firms. As of June 30, 2010, MFDA Fund assets stood at $27.8 million. In addition, the MFDA Fund maintains a $30 million bank credit facility. This facility is guaranteed by the MFDA. The MFDA Board of Directors has adopted a resolution to increase the size of the MFDA Fund to $50 million over the next seven years.

IV. The pervasive impact of bankruptcy law

The determination of the financial assets owned by financial consumers and the shortfall in the value of such assets, if any, which were under the management of an insolvent financial services firm immediately brings to the fore the legal constraints that govern bankruptcy proceedings and their uneasy interplay with investor compensation schemes. The efficient management of these interdependencies is critical to the liquidation of the firm in a manner that best serves the interest of financial consumers and to the performance of investor compensation schemes. This applies in all jurisdictions; Canada is no exception.

In Canada, bankruptcy and insolvency is an exclusive legislative competence of the federal Parliament[5]. In the event of incompatibility between the provisions of the *Bankruptcy and Insolvency Act* or the *Companys' Creditors Arrangement Act* (''CCAA'') and a provincial law, the former prevail.

In 1997, the *Bankruptcy and Insolvency Act* was amended to incorporate Part XII - *Securities Firm Bankruptcies* in order to simplify and streamline the administration of a bankrupt securities firm's estate. Prior to this amendment, liquidation of these estates was time-consuming, complex, uncertain, and costly to both investors and creditors. Customers of the bankrupt firm would raise a myriad of competing claims creating litigious conflicts which proved difficult and costly to resolve. Often, while waiting for adjudication of these claims, the trustee in bankruptcy would have to hold volatile securities while customers battled over their entitlement to these assets.

The definition of *securities firm* under the Act is much wider than the usual definition in securities legislation. Any person required to be registered to enter into securities transaction with the public is a *securities firm*. Thus, mutual fund dealers are *securities firms* under the Act. A firm qualifies as a *securities firm* even if only part of its business consists in the buying and selling of securities; it may be its primary business, or it may simply be part of its overall business. Hence, a duly registered portfolio manager may be a *securities firm* even though unregistered as a broker. An investment company engaged in day trading with investors' funds in equity markets is also deem to be a *securities firm* under the Act[6].

Part XII of the *Bankruptcy and Insolvency Act* creates three distinct baskets of financial assets:

- Customer name securities: these assets do not vest in the trustee as they are owned by the customers. If and when identified, they must be returned to their ''owner'' (e.g. the financial consumer). In practice, this is normally affected by the bulk transfer of the customer accounts to another registered dealer in good standing.

- The Customer pool fund: the pool fund is constituted with all the cash and securities (other than Customer name securities) held by the bankrupt securities firm. The assets in the Customer pool fund are allocated in the following order of priority: (i) for costs of administration to the extent that sufficient funds are nor available in the general fund to pay such costs; (ii) to customers in proportion to their net equity; and (iii) to the general fund. In effect, this provision creates a *priority* status for financial consumers

[5] Para 91 (21) of the Constitution Act of 1867

[6] A bank, a member of the Canadian Payments Association and local cooperative credit societies member of a central cooperative credit society are not a *securities firm* since they are excluded from the definition of ''corporation'' under section 2 of the *Bankruptcy and Insolvency Act*

- The general fund which includes all remaining property of the bankruptcy securities firm.

Two other important features of Part XII of the Act are:

- The right given to securities regulators to file an application for a bankruptcy order in respect of a registered securities firm which has been suspended due to its failure to meet the capital adequacy requirements.

- The exceptional status given a *customer compensation body* recognized under the Act which has the right to file an application for a bankruptcy order in respect of an insolvent securities firm and the right to participate in the administration of a bankruptcy estate by designating an inspector. The trustee in bankruptcy has the obligation to consult with the *customer compensation body* throughout the liquidation process.

IPC was recognized on March 25, 2011, as a *customer compensation body.* **FISF does not possess this recognition and, therefore, it (and the AMF) does not have the privileged standing vis-à-vis the trustee in bankruptcy provided in Part XII of the Act**.

The AMF is not without tools to deal with the failure of a *securities firm*. First, at the request of the AMF, the Bureau de décision et révision can issue ''cease and desist'' orders which may effectively result in freezing the assets of the firm located in or controlled from Quebec. Second, it can have a receiver appointed by the Superior Court under the *Act Respecting the Autorité des marchés financiers*[7]. Under the Act, the Superior Court may also, in certain circumstances, order the winding-up of a person, partnership or other entity and appoint a liquidator, or assign all their property for the benefit of its creditors and appoint a trustee[8]. Although this may cover a situation that is circumscribed to Quebec, it does not limit initiatives on the part of the principals of the delinquent firm during the 10 days notice period pending the appointment of the receiver. This was clearly demonstrated in the Norbourg saga. Moreover, the provisions of the Act do not give financial consumers priority over other creditors, as provided in federal legislation.

The inescapable conclusion is that the means available to a liquidator or receiver appointed under Quebec law are not up to the task in complex bankruptcy cases.

- The FISF is not an insolvency protection insurance program. One important consequence stemming from its limited and singular mandate is that FISF (and AMF) is deprived of the important benefits available to *customer compensation bodies* recognized under *the Bankruptcy and Insolvency Act*. This status gives the right to **participate in the**

[7] Act respecting the Autorité des marchés financiers, R.S.Q. c. A-33.2, sections 19.1 to 19.7 and section 239 (5) of the Quebec Securities Act.

[8] At the time of the Norbourg affair the receivership and winding-up procedures were different. The *Quebec Securities Act* then provided that the Minister of Finance could, upon a recommendation from the Bureau de décision et de révision, order the liquidation of a registered person or company and appoint a liquidator to implement the order. This is the route the AMF followed in the Norbourg case.

administration of a bankruptcy estate by designating an inspector and be consulted by the trustee in bankruptcy.

- Several recent bankruptcies of pooled or mutual funds were Ponzi schemes where the returns paid to investors were bogus investment earnings and the redemption of the investment was funded by the embezzlement of the investments made by other investors. Such situations give rise to numerous intricate problems. For instance, how should the ''net equity value'' of each financial consumer be determined? The equitable rule is that the cash payments (e.g.cash in and cash out) are the determinant factors, a treatment that inevitably spurs litigation from aggrieved investors.

  Under Canadian bankruptcy law, the trustee can recover the payments made in the three months preceding the date of bankruptcy since they would be deemed preferential payments[9]. Moreover, within the first year of his appointment, the trustee in bankruptcy may avail itself of the paulian remedy under the Civil Code to claw back fraudulent payments made up to three prior years. ''Fraudulent conveyance'' provisions to the same effect are generally available under other provincial statutes. Clearly, the ability to engage with the trustee as these decisions are contemplated constitutes a crucial advantage and may be decisive for the fair treatment of Quebec financial consumers.

- A rigorous assessment of the tools and means at the disposal of the AMF under Quebec law fails to provide comforting answers to the question ''what if'' the operations of the bankrupt firm were mainly outside Quebec?

  As of June 30rd, 2011, 90% of the assets under administration were ''located'' in Ontario (72%) and Manitoba (18%); Quebec accounted for only 4% of the total. Comfort may reside from the fact that regulations forbid ''Level 2'' and ''Level 3'' MFDA mutual fund dealers from holding customer assets. Nevertheless, experience in Europe and North America has shown that breach of such regulations has occurred in several instances, mainly among smaller independent firms. The failure of Essex Capital Management Ltd, an introducing broker, which has cost $6.1 million to CIPF is a case in point.

  By whom would financial consumers in Quebec be compensated in the event of a failure of a mutual fund firm active in Quebec but with its head office in another province? Under the current system, certainly not by IPC; would FISF (or the AMF) leave them ''out-to-dry'' if no fraudulent activity occurred in Quebec?

- The maximum coverage provided by IPC in the event of insolvency of a mutual fund dealer is $1.0 million for a general account and $1 million for a separate retirement account (i.e. for up to $2 million in total per client) whereas FISF provides a maximum coverage of $200,000. Should a national firm fail, would this substantial differential in insurance coverage be acceptable to Quebec injured consumers?

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9 This period is extended to twelve months for dealings with a party not dealing at arms' length.

Quebec financial consumers are short-changed in their level of protection by a regime that does not reflect the fact that a substantial part of the mutual fund industry active in Quebec is comprised of firms domiciled in other jurisdictions. The complex legal structures, including regulated and unregulated entities, that do not necessarily correspond to integrated, interconnected operating structures and the national and international scope of operations complicate bankruptcy proceedings. Experts generally agree that it is imperative to provide regulatory input in the bankruptcy process, particularly in complex multi-jurisdictional bankruptcy processes. The current Quebec approach deprives the AMF – and consequently Quebec financial consumers – of the ability to exert a direct influence on the actions and the decisions of the trustee in the course of a mutual fund dealer bankruptcy proceedings.

V. The performance of the FISF compared to other investor compensation schemes

The financial costs incurred by the four comparable North American investor compensation schemes to cover the shortfall in assets resulting from the insolvency or the fraudulent actions of securities or mutual funds dealers provide useful insights for the assessment of the performance of the FISF.[10]

- Since the inception of SIPC in 1971, the total value of the assets returned to customers of bankrupt US securities firms amounts to $109.3 billion. Recoveries from the estates of the bankrupt firms amounted to $108.2 billion. The net payments made by SIPC during the 1971 – 2010 period amounted to $1.6 billion (i.e. $1.1 billion in compensation and $0.5 billion in administration expenses). The net cost to SIPC represents 1.46% of total distributions of financial assets returned to these customers. Because of the limits of protection provided by SIPC, some claims were not completely satisfied. These cases are in the minority: 351 claims out of 625,100 claims with an unsatisfied portion valued at $47.2 million.

- The total cost incurred by CIPF since its establishment in 1969 to satisfy claims and related expenses amounts to $33.3 million, net of recoveries. Quebec-based securities firms account for only 1.35% of this total net cost[11].

- IPC began offering coverage on July 1, 2005. Since that time, it has dealt with the insolvencies of [three] mutual fund dealers[12]. The total net cost to IPC of compensations paid to injured financial consumers is less than $100,000. In most cases, the customer accounts were rapidly transferred to another dealer and no claims to IPC have arisen as a result.

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[10] The investor compensation schemes are the US Securities Investor Protection Corporation (''SIPC''), the Canadian Investor Protection Fund (''CIPF''), the MFDA Investor Protection Corporation (''IPC'') and the Fonds d'indemnisation des services financiers (''FISF'')

[11] CIPF does not report the value of recoveries during the whole period 1969-2010. The financial statements indicate that recoveries for 2009 and 2010 alone amounted to $3.2 million or 9.6% of the total net disbursements by the Fund since inception.

[12] IPC reports one insolvency (Quebec) in 2007-2008; two insolvencies (Ontario) in 2008-2009 (i.e. Farm Mutual and ASL Direct) and none in the 2009-2010 and 2010-2011 fiscal years (Source: Annual Reports). IPC does not report in a summarized manner the compensation paid to financial consumers harmed by the failure of a mutual fund dealer since inception. IPC reports a net cost of $63,300 for ASL Direct; the other cases did not result in any claim on IPC.

- Since 1999, FISF paid a net amount of $45.8 million in compensation to 1,399 eligible claimants[13]. The total amount of recoveries was $3.0 million or 6.1% of the amounts paid. During the 2004-2010 period, 75% of eligible claims were related to the distribution of mutual funds; the compensation paid for those claims amounted to $37.8 million, representing 82.5% of the total amount of FISF compensation payments, to which the $20 million paid by the AMF in the settlement of the class action by some Norbourg investors should be added.

Several observations are in order. Firstly, investment dealers and securities broker-dealers are inherently more risky enterprises than mutual fund dealers. The former generally engage, as a matter of course, in making margin loans and in proprietary trading whereas the latter are precluded from conducting such activities.

MFDA classifies its 132 members in four categories. Only 36 level 4 mutual fund dealers are permitted to hold client assets, other than cash, in nominee name. It is estimated that about 84% of the assets of customers of mutual fund dealers invested in mutual funds are held at the mutual fund in client name. Consequently, in the event of a bankruptcy and the absence of fraud, the transfer of the customer account to a mutual fund dealer in good standing is a relatively straightforward exercise.

In this context, the significant higher cost incurred by FISF ($37.8 million plus $20 million) since 1999 to compensate financial consumers injured by the fraudulent actions of mutual fund dealers compared to the total net cost to CIPF of $33.3 million since 1969 (Canada-wide and exposed to significantly more extensive and complex activities) and the total net cost of $0.1 million to IPC since 2005 (Canada, excluding Quebec), raises serious questions as to the underlying factors that produce such a different burden.

Secondly, AMF reports that FISF recoveries from the delinquent registrants (or estate of insolvent firms) represent 6.1% of the compensation paid. In the case of CIPF, recoveries in 2009 and 2010 alone represent about 9.6% of the total compensation paid since 1999.

Thirdly, time is of the essence when dealing with financial services firm on the verge of or in default. Any delay in taking control of a financial services firm once its financial integrity is questioned by regulators accelerates the dissipation of customer assets and lessens the potential for recoveries.

In Canada, the legislation dealing with the bankruptcy of banks, federally incorporated insurance companies and broker-dealers give broad and immediate control to the regulators to take control of the proprietary assets and those under administration by the firm and effect the orderly liquidation

[13] This amount does not include the $20 million portion of the $55 million out of court settlement of the class action paid by the AMF to the Norbourg financial consumers which had been denied compensation by FISF on the grounds that they did not have an eligible claim under the rules of the scheme. This amount is considered by the AMF to be a settlement, not compensation and, consequently, not imputed to FISF. ''The $55 million, in addition to the compensation already paid by the *Fonds d'indemnisation des services financiers*, administered by the *Autorité des marches financiers* (AMF), the funds recovered by the bankruptcy trustees and the liquidator in the Norbourg matter and the funds returned by Revenu Québec, will ensure the recovery and distribution, to all intents and purposes, of all funds stolen from the Norbourg victims.'' (AMF – January 2011)

in cases where the firms do not meet established capital thresholds[14]. For instance, in the case of a securities firm, the law states unequivocally that the suspension of a broker-dealer by a securities commission or a securities exchange **constitutes an act of bankruptcy if the suspension is due to the failure of the firm to meet capital adequacy requirements.**

In the United States, the SROs and the SEC are required to immediately report to SIPC concerning any member **who is in or approaching financial difficulty**. SIPC can then apply to a Federal District Court for the appointment of the trustee it recommends to carry out the liquidation. Upon application to the Court, the assets of the firm are under the exclusive jurisdiction of the Court and all proceedings against the firm are stayed. In the Madoff case, the arrest of Bernie Madoff occurred on Thursday, December 11th, 2008. The trustee selected by the SEC/SIPC was appointed by the court on Monday, December 15th, 2008. The ''effective date'' was determined to be December 11th; all the assets, including Madoff's personal assets, were frozen by the court as of that date.

In the Norbourg case, the fraudulent activities were reported to the authorities on June 21st, 2005. The AMF took control of four main entities of the Norbourg Group and the mutual funds on August 25, 2005, with the appointment of a provisional administrator. The provisional administrator submitted a preliminary report on September 26, 2005, indicating that the shortfall in customer assets was in the order of $130 million. On October 13, 2005, Norbourg Group's principal put the five main entities of the Group into bankruptcy and a trustee in bankruptcy was appointed. Since the funds were constituted as ''trusts'', they could not technically be declared bankrupt under the law[15]. A liquidator was appointed on October 25, 2005 by the Minister of Finance to wind-up the mutual funds. The final outcome was that the Norbourg companies were liquidated by the trustee appointed pursuant to the *Bankruptcy and Insolvency Act* whereas the mutual funds were liquidated by a Quebec appointed liquidator under the *Quebec Securities Act*[16].

VI. KEY STRUCTURAL RECOMMENDATIONS

1. <u>Insurance Coverage</u>

- The AMF should require mutual fund dealers active in Quebec to maintain insurance coverage as per NI 31-103, including fidelity insurance.

  Fidelity insurance is considered in all other jurisdictions as the best approach: it is a more efficient means to protect consumers; it assigns the responsibility to compensate customers to whom should bear the consequences and, it avoids the dysfunctional impact associated with public or mutualised industry funds such as the FISF.

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[14] *Financial Institutions Amendment Act*, 1997, s.c. 1997 (Bank Act and Insurance companies Act), *Winding-up and Restructuring Act*; *Bankruptcy and Insolvency Act*, R.S.C., 1985, s.B-3 (Part XII).

[15] This conclusion remains valid under either common law or civil law

[16] At the time of the Norbourg affair the receivership and winding-up procedures were different. The *Quebec Securities Act* then provided that the Minister of Finance could, upon a recommendation from the Bureau de décision et de révision, order the liquidation of a registered person or company and appoint a liquidator to implement the order. This is the route the AMF followed in the Norbourg case.

The AMF implicitly accepts this assessment. It is noteworthy that (a) securities firms member of IIROC active in Quebec are required to maintain fidelity insurance coverage – not professional liability coverage; (b) they are excluded from coverage by FISF; and (c) the AMF consultation is mainly directed towards the coverage provided by FISF and not about that of the securities industry Canadian Investor Protection Fund (''CIPF'').

2. Design of the investor compensation scheme

- Quebec customers of mutual fund dealers should be covered by an insolvency protection scheme. This scheme should be a non-governmental stand-alone organization which is:

  - Distinct from the AMF, managed by industry representatives and independent directors familiar with the industry and the processes governing the liquidation of financial services firms;

  - Recognized as a *customer compensation body* under the *Bankruptcy and Insolvency Act*. This very important status is unattainable by FIFS since its purpose is not in accordance with the object of the Act;[17]

  - Capitalized at a level commensurate with the risks to which it is exposed as is the case for other investor protection schemes. All committees or task forces which have examined the matter in other jurisdictions have concluded that such schemes needed to be capitalized to a prudent level, even when they had access to emergency government funding. A seven to ten year period coud be given to reach the fund's target level.

3. Regulatory oversight

- The AMF should delegate the responsibility to audit and monitor the compliance of mutual fund dealers with respect to capital adequacy rules and other business conduct requirements to a SRO competent to carry-on such a critical function.

  The current atypical arrangement brings about several negative consequences. In particular, it:

  - deprives the AMF and the industry from the benefits stemming from the extensive business knowledge arising out of experience and proximity to the industry players and the speed of adaptation to changes in industry practices which are the hallmark of SRO supervision.

  - eliminates the benefits accruing from a two-level supervision arrangement. When an SRO assumes the surveillance responsibilities, the regulatory agency performs an oversight function with respect to the performance of the SRO. This

[17] The same conclusion applies with respect to the Anti-Fraud Indemnity Fund proposed by the Coalition for the protection of investors.

''second look'' is critical and serves as a pointer for continuous improvement. The AMF cannot oversee itself. Moreover, the current approach increases moral hazard; how can AMF deny responsibility for mishaps in the regulatory function when it is the one exercising the surveillance function?

- leaves no other option than foistering on the AMF the responsibility to manage FISF since it carries out the surveillance of dealers compliance with respect to prudential regulation. Such a position is generally shunned by North American regulatory agencies.

- imposes added compliance costs for MFDA mutual fund dealers active in Quebec who are subject to MFDA, AMF and CSF supervision and audits.

- results in Quebec customers of mutual fund dealers not being covered for any losses arising out of the bankruptcy of a mutual fund dealer for reasons other than fraud against Quebec financial consumers.

- imposes a heavier financial burden on the Quebec industry. Since the risks insured by such a compensation fund are determined by the largest exposure and not by the average or median value of financial assets under management, the levies required from the industry will necessary be higher for a Quebec fund compared to a pan-Canadian fund. Indeed, we observe that FISF is in a deficit position whereas IPC fund maintains a capital base of about $30 million (slated to increase to $50 million).

Recognition of MFDA as a SRO by the AMF would eliminate to a considerable extent the negative consequences described above and provide enhanced protection to Quebec customers of mutual fund dealers in the most efficient and economical manner. The AMF experience with IIROC demonstrates the substantial benefits of such an approach. For Quebec mutual fund investors, it would have the added advantage of eliminating the disparity in coverage between those who invest through a mutual fund dealer rather than a securities dealer.

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