A ROADMAP FOR STRENGTHENING THE PROTECTION OF QUEBEC MUTUAL FUND INVESTORS

A SUBMISSION
TO THE
AUTORITÉ DES MARCHÉS FINANCIERS

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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 investor compensation scheme and the industry has been the locus of major bankruptcies in the recent past.

The security of the savings of Canadians invested in mutual funds is a legitimate area of concern for public policy. About 13% of Canadian families own units or shares of mutual funds; it represents a significant proportion of their wealth held in financial assets. In the second quarter of 2011, the value of the assets held by Canadians in mutual funds amounted to $756.2 billion; Quebecers held $117 billion at the same date, representing 15% of the total. Approximately 46% of mutual fund units or shares owned by Quebec financial consumers are held in the custody of a deposit institution. On average, in 2011 in Quebec, retail securities and mutual fund dealers ''sold'' approximately $40 million per month in mutual funds. Retail securities and mutual fund dealers affiliated to a deposit-taking institution collected about $38.3 million and those affiliated to an insurance company, approximately $1.6 million. The remainder was sold to financial consumers by Quebec independent mutual fund dealers[2].

Restoring trust in the financial system is not the same as reforming the financial system; financial consumer protection is an essential part of the former. According to the OECD, financial consumer protection against fraud and misuse of consumer assets needs to be given "the recognition and emphasis it rightly deserves" and "special attention should be dedicated to the needs of the vulnerable groups". The following five factors exert considerable weight on public attitudes and policies aimed at strengthening financial consumer protection:

- The sheer size of the financial assets owned by individual investors stemming from the structural demographic shift acts as a magnet for both the *bona fide* financial industry and, unfortunately, less legitimate organizations or ethical individuals.

- A substantial portion of these financial assets are owned by investors 55 years of age or older. These investors are often unfamiliar with investment matters and much more

[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

[2] Institut de la Statistique du Québec, « Courtage de détail en valeurs mobilières au Québec », and ''Fonds communs de placement au Québec'', 2011.

likely to be susceptible to manipulation. The Canadian Ombudsman for Banking Services and Investments (''OBSI'') reports that 53% of the complaints they investigated were made by individuals over the age of 60. Moreover, the loss or impairment of their savings has a considerable social and personal impact because they are retired or their remaining earning horizon is very short. For them, the important question is not ''how much did they lose'' but the much more fundamental one: ''how much do they have left?''

- A growing concern that the savings of individual Canadians will be insufficient to support decent retirement income. The fundamental change in the pension system from defined benefit plans to defined contribution plans, money-purchase arrangements or individual retirement savings plans has transferred longevity and adequacy of retirement income risks to a majority of individual Canadians. These risks are compounded by the low level and high volatility of prevailing market rates.

- Recent cases of fraud have caused severe harm to many investors and hurt confidence in the regulated financial sector because of the magnitude of the losses, the difficulties of untangling complex legal issues and the substantial delays they cause in returning assets to investors or in determining the amount of compensation they will receive[3]. The media focus on each step of the compensation process, particularly mishaps, heightens the concerns of investors and encourages regulators and elected officials to take action.

- The number of individuals duped by scam artists that have lost a substantial portion of their savings and who have been denied compensation such as in the Mount Real or Earl Jones frauds is deemed unfair, particularly since the Quebec compensation scheme is a part of and managed by the regulator responsible to eradicate such ''bad actors''. In light of the jurisprudence in several key jurisdictions, the argument that regulators and investors compensation schemes have no responsibility for losses incurred as a result of a fraud by a non-registered entity increasingly rings hollow.

The search for efficient means to enhance investor protection without stifling innovation and competition within the financial industry is a worldwide concern. In the United States and in the European Community, we observe, amongst many developments, that:

- The Dodd-Frank Act eliminated several restrictions related to "Fair Funds" in order to increase the amounts available to compensate investors for losses stemming from fraud and other unlawful actions. It also provides grants to States for enhanced protection of seniors against misleading and fraudulent marketing and sale tactics. Moreover, the Act

[3] Examples of recent cases include Portus Alternative Asset Management (Ontario), Norbourg (Quebec), Norshield (Quebec), Farm Mutual (Ontario), Manna (British Columbia), Thow (Alberta & BC), Madoff (USA), Phoenix Kapitaldienst (Germany).

instructs the Controller General of the United States to conduct studies regarding mutual fund advertising, financial planners and the use of financial designations.

- The European Union Investor Compensation Schemes Directive adopted by the European Parliament on July 5th, 2011, aims at protecting investors against fraud, administrative malpractice, operational error or bad advice. ICSD entitles clients to compensation whether or not the firm holding, administering or managing client assets is authorized to conduct such activities.

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 and mechanisms with tort, bankruptcy and other pertinent laws and the experiences and the lessons learned by other jurisdictions in dealing with such situations.

This submission is structured as follows. In the first part, we summarize the policy issues associated with the design and workings of investor compensation schemes. In the second part, we provide a general overview of investor compensation schemes in several jurisdictions. We first review the policy direction pursued in the European Union with to the adoption by the European Parliament on 5 July 2011 of its report concerning the European Commission proposal to amend the Investor Compensation Schemes Directive (''ICSD''). We follow with a review of the approach to investor compensation in the United States with emphasis on the Securities Investor Protection Corporation. Fair Funds and the role of the states are also discussed. We conclude this part with an overview of three schemes in Canada: the Canadian Investor Protection Fund, the MFDA Investor Protection Corporation and the Fonds d'indemnisation des services financiers.

In the third part, we provide a general overview of the bankruptcy proceedings applicable to securities firms in Canada since they are intimately related and a key to the performance of investor protection schemes. Our observations with regard to the Quebec approach to investor compensation as it applies to mutual funds are formulated in the fourth part. The design rationale of the Fonds d'indemnisation des services financiers and its relative performance are examined in light of the assessment of the risks presented by financial services firms, in general, and the structural characteristics of mutual funds in Canada, in particular, and then compared to other compensation schemes. Our recommendations and their rationale form the content of the fifth part.

I. POLICY ISSUES ASSOCIATED WITH INVESTOR COMPENSATION SCHEMES

Pressured by the dynamics put in motion by the recent financial crisis and their interplay with the environmental factors enumerated above, governments and financial regulators worldwide are groping with the public policy issues arising from the failure of banking, insurance, securities and heretofore non-regulated financial firms. Contingency funds established to insure depositors, insurance policy holders and securities industry customers against losses that may arise from the failure of a financial services firm are prevalent worldwide and they constitute a common feature of a sound financial sector regulatory regime.

1.1 Deposit issuance and investor compensation schemes

There are significant differences between the motives which underlie deposit insurance programs and those which pertain to investor compensation schemes. In the case of deposit taking institutions, the main impetus is to reduce and mitigate systemic risks by preventing a "run on the bank" where the rush for withdrawing deposits or non-segregated assets from financially viable institutions gives rise to liquidity issues which, in turn, causes them to become insolvent and further fuels the withdrawal stampede. Financial consumer protection is a by-product, nice to have but not the determining reason. And because of the criticality of deposit taking institutions to the payment system and recognition that the main purpose of bank accounts is to pay for regular consumption or business operations, speed in resolving the situation is of the essence.

The strong emergency actions taken by the U.S. Treasury and the Federal Reserve to arrest the unprecedented run on money market funds in September 2009 is a case in point. Money market funds in the United States are regulated as mutual funds whereas they are used by investors as deposit institutions. There was no contingency fund or mechanism to protect against a ''run'' on such funds. In order to arrest the withdrawal stampede and gradually restore the functioning of short-term commercial and institutional capital markets, the U.S. Government had to establish the Treasury's Temporary Guarantee Program for Money Market Funds and the Federal Reserve's Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility.

Although unit holders who remained in the funds (mainly retail investors) benefitted from the Government actions, these were driven by the overriding goal of mitigating the systemic risks by slowing the run on money market funds and stabilizing the markets for commercial paper and other short-term debt instruments.

In contrast, investor compensation schemes are established to instill confidence in the financial industry by providing a certain level of protection to financial consumers against the dissipation in the value of their financial assets caused by mismanagement or unlawful actions by financial services firms when all other business or regulatory safeguards have failed. In essence, it is a matter of fairness or, in economic terms, a mutualisation of the risks in order to reduce the social and individual cost of pursuing tort redress through the Court system or of bearing the full cost of the dissipation of one's savings due to the actions of the financial services firm. From a social viewpoint, this mutualization of the residual risks borne by financial consumers is warranted because they cannot insure themselves against the harm created by the failure of or fraud committed by ''their'' financial services firm.

1.2 The major policy issues

The major policy issues can be summarized as follows:

- **Efficient capital markets:** Efficient capital markets are a public good; therefore, it is incumbent upon the State to protect and promote them. Experience shows that loss of trust in the integrity of capital markets and the financial industry following major failures or scandals leads to investors withdrawing from markets. Consequently, the capital formation process and allocation efficiency of capital markets is impaired.

  The arsenal of tools used by public authorities to avoid such detrimental outcomes relies on prudential regulation and the regulation of business conduct. The first aims at ensuring the financial robustness and financial integrity of financial services firms, mainly through the establishment of prudent capital adequacy requirements and their monitoring. The second, which pertains mostly to financial consumer protection, relies heavily on the adoption of proficiency standards and requirements for all sales and management personnel dealing with retail investors and the implementation of compliance mechanisms to ensure adherence to regulations, rules and code of conduct.

  Financial consumers who chooses to invest in securities accept the risk that the market value of the investment may increase or decrease. The consumer does not invest with an expectation that there will be a dissipation in the value of an investment caused by illegal or improper activity or mismanagement. Investor compensation schemes are the last rampart of consumer protection, if and when the extensive regulatory apparatus fails to prevent the failure of a financial services firm.

  The central and pervasive role of the State in regulating the financial sector gives rise to moral hazard. When lapses in regulation or surveillance result in harm to investors, public authorities are increasingly being considered as responsible, if not complicit, of the 'breakdown' and its effects.

- **Coverage policy:** The statement that, except for the Fonds d'indemnisation des services financiers du Québec ("FISF"), investor compensation schemes in Canada, Europe or the United States do not compensate losses triggered by fraud is misleading. The general rule is that investors are compensated for losses arising from the failure of "their" financial firm; such failures are generally the result of or influenced by fraud, as evidenced in the Madoff and Norbourg cases. These occurrences create the most injury to investors because of the number of individuals impacted and the value of the financial assets in limbo.

Therefore, the nexus of the policy debate does not hinge on the matter of compensation for fraud and administrative malpractice-related losses but whether compensation should be available from an investor compensation scheme in cases where a) a registered financial services firm remains solvent, b) the firm or person carrying the financial services activities is not authorized to provide the specific services, or c) the firm or individual engage in financial services activities is a non-registered entity altogether.

The registration requirements for financial services firms generally impose on registrant firms that they maintain fidelity insurance to cover losses stemming from employee dishonesty, embezzlement, forgery, robbery, safe burglary, computer fraud, wire transfer fraud, counterfeiting, and other criminal acts caused by employees. Consequently, as long as these malevolent actions do not cause the demise of the firm, there is no need for the intervention of an investor compensation scheme since the losses are covered by the insurance, thus ensuring that sufficient funds are available to compensate harmed customers.

The traditional paradigm in cases of financial losses arising from fraudulent activities or mismanagement can be described as *caveat emptor* with recourse to the Courts under the general umbrella of tort laws to obtain redress. Recent trends in legislation privilege statutory investor protection as a means to minimize the need for financial consumers, individually or in group, to seek redress in Court.

The fundamental principle governing the operation of all private or public contingency funds is that losses that result from the decline in the market value of the financial assets owned by depositors or investors are not covered by investor compensation schemes. Indeed, this risk constitutes the essence of an investment. The Courts have generally upheld this position.

- **Market conduct standards:** Regulation of the financial sector imposes proficiency standards, education and experience requirements to ensure the competencies of all personnel involved in the management and sale of financial products and services to retail investors. These professional qualifications posit that these individuals have sufficient knowledge of financial and investment matters to ensure that their advice to retail customers is of value. But what if, because of recklessness, unethical conduct or sheer incompetence on the part of a licensed professional, an investor finds the value of his portfolio (or savings) seriously impaired? In a nutshell, this is the flip side of the value of advice argument; how should public policy address the situations where the advice had negative value?

Regulations generally impose on securities and mutual funds sales representatives and their firms, the 'know your client' rule which requires registrants to take reasonable steps to obtain and periodically update information about their customers and ensure that a proposed transaction is suitable for a customer before making a recommendation or accepting instructions from the customer. Ensuring the suitability of investments and investment advice is not a trivial compliance matter; it has been the number one investment complaint topic to OSBI for several years, accounting, in 2010, for 22% of the total number of banking and investment complaints.

The regulations applicable to securities firms and their representatives in Quebec with respect to their dealings with financial consumers are akin to the regimes in force in other jurisdictions. They rest on the basic tenet that they have a fiduciary obligation with respect to their clients which entails the duties of loyalty, competency, prudence, diligence and of ensuring that their recommendations are suitable to the needs or expressed preferences of each client[4].

Accordingly, it is generally accepted that the first recourse of a customer who has been deprived of his financial assets because of malevolent actions or incompetence of its employees should be to that customer's financial firm[5]. Well capitalized corporations are best able to compensate the injured customer for the actions of an employee. Moreover, such corporations carry ''errors and omissions'' and fidelity insurance policies that cover the damages caused by errors and omissions fraud and dishonest acts made by employees in the course of business.

In order to avoid the costs and efforts required to settle disputes between financial consumers and the financial services providers and accelerate the fair resolution of disputes, the various segments of the financial industry, with the support of regulatory authorities, generally establish an independent dispute resolution body to hear and mediate the settlement of financial consumer's complaints[6]. This service is generally free to consumers. Recourse to such a mechanism is often mandatory for members of

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[4] *For a detailed review of these obligations under Quebec law, see Raymonde Crête, Les manifestations du particularisme juridique des rapports de confiance dans les services de placement* dans Raymonde Crête et al. *Courtiers et conseillers en placement – encadrement des services de placement,* Montréal Éditions Yvon Blais 2011, pages 302 à 315.

[5] The legal and regulatory framework which governs access and eligibility of a registered representative or other key functions in the securities industry is, in several respects, akin to those that apply for the recognition of a professional order. It has been suggested that these similarities justify the statutory recognition of financial intermediaries as a profession. Whatever the status granted in the future, it will not change the fact that registered individuals conduct their business as an employee or agent of a financial services firm. The regulatory framework must reflect and be in line with this commercial reality. Failure to do so, will inescapably reduce – even compromise – financial consumer protection. See Raymonde Crête, *Les manifestations du particularisme juridique des rapports de confiance dans les services de placement* dans Raymonde Crête et al. *Courtiers et conseillers en placement – encadrement des services de placement,* Montréal Éditions Yvon Blais 2011, pages 302 à 315..

[6] Anne-Marie Poitras, *Le dédommagement des consommateurs dans le cadre d'un mécanisme de règlement des différends* dans le cadre du Colloque *La confiance au cœur de l'industrie des services financiers,* septembre 2009.

self-regulatory organizations ("SRO''). In certain jurisdictions, the resolution mechanism includes arbitration, with the decision binding on the parties.

The specific nature of investment services provided to financial consumers by a registered representative and financial services firms embody an added dimension of trust on the part of the consumers compared to other commercial transactions. In fact, this relationship gives rise to fiduciary responsibilities. When entrusting a securities or mutual fund dealer with part of his or her assets, the former accepts that he has contracted loyalty and good faith obligations and that he has the fiduciary obligation to always act in the best interest of the customer. In a recent academic study, the author concludes ''a common strand emerges which finds its expression through an increase of the obligations imposed on financial intermediaries and a corresponding reduction of those borne by financial consumers, in conjunction with specific penalties related to registered persons providing investment services''[7]. However, in some jurisdictions, these legal responsibilities do not always apply uniformly to all categories of 'financial advisors' when financial consumers receive personalized investment advice, an issue that is gaining salience in the debate, notably in the United States[8] and in Ontario[9].

- **Regulation of the industry:** Government regulators and self regulatory organizations (''SRO'') operate at arms length from the firms or persons they regulate. The harsh reality is that bad faith or unethical dealings, false or misleading representations, unlawful conduct and fraud are endemic to the financial industry. The sad fact is that even in large financial institutions with a strong supervision discipline and a thorough compliance department, such reprehensible conduct occurs. For instance, OBSI opened 1024 case files in 2010.

  Clearly, egregious and fraudulent conduct in the large Canadian financial firms is limited to a small number of individuals. The point, however, is that if comprehensive, competent and dedicated compliance organizations cannot eradicate delinquent behaviour by employees under the direct management and control of the firm, how can one expect regulators overseeing at arms length a diverse and fragmented industry achieve a zero-fault result?

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7 Our translation : Raymonde Crête, « Les manifestations du particularisme juridique des rapports de confiance dans les services de conseils financiers et de gestion de portefeuille », Partie III, Dossier « La confiance au cœur de l'industrie des services de placement », Revue générale de droit, Vol. 39 n°2, 2009, Université d'Ottawa.

8 For instance, the Dodd-Frank Act empowers the SEC to ''harmonize'' the standard of conduct for such brokers and dealers with that presently imposed on investment advisers, requiring them to ''act in the best interest of the customer without regard to the financial or other interest of the broker, dealer, or investment adviser providing the advice,'' and to disclose ''any material conflicts of interest.'' (§913(g) and (h)). See also the ''Study on Investment Advisers and Broker-Dealers'' by the Staff of the SEC (January 2011).

9 The Globe and Mail, ''The flaws in Canada's financial adviser system'', February 17, 2012

This constitutes a major policy conundrum. On the one hand, the independence and arm length relationship between the regulators and the industry is considered a mandatory condition for the integrity, credibility and performance of regulators. On the other hand, the parallel structure hampers the regulators' capabilities to prevent malevolent behaviour, and hence, weakens financial consumer's protection because the regulators are not positioned at the confluence of the flows of information within the industry and the market. This structural issue is highly relevant to the regulation of mutual fund dealers in Quebec because, contrary to the situation that prevails in other parts of Canada and for securities firms across Canada, the surveillance of the firms (as distinct from individual representatives), is carried-out by the AMF rather than an industry SRO.

Financial and operational risk exposures for financial consumers cannot be considered without reference to the structure of the market within which their investment activities takes place. For example, the risks are affected by the types of intermediary through which the investment is undertaken. Therefore, the risks to financial consumers and the regulatory approaches need to be analysed in the context of the industry structure.

A firm's reputation is an institutional form of investor protection that may work both *ex ante* and *ex post*. Firms that value their reputation will be careful to ensure that they are consistently delivering high-quality work and acting in the best interest of their clients. This will help to induce the firms to reduce the likelihood of risks that may lead to losses to financial consumers, for example by implementing internal systems and controls as part of a risk management strategy. Where problems do arise, strong firms are likely to compensate investors for any losses they incur, so as to preserve their reputation.

The number of cases opened by the Chambre de la sécurité financière reflects the level of concentration in the Quebec mutual fund industry. In 2010, mutual fund representatives represented 73% of the total number of registered representatives under the Chamber's purview whereas this industry segment accounted for 29% of total number of open cases for claims. The number of representatives involved in those cases represented less than 1% of the total number of representatives.

Large Canadian financial institutions are poised to protect the sizeable investment made consistently over the years to establish their reputation and earn the trust of their customers. The management of reputational risks is a major concern for such corporations and decisive actions will be taken to avoid being tainted as non-trustworthy. Two recent examples that pertain to mutual funds demonstrate that these considerations are not vain expectations of corporate behaviour.

On August 20th, 2007, at the onset of the asset-backed commercial paper (''ABCP'') crisis, the National Bank of Canada (''NBC'') voluntarily took the decision to acquire at 100% of the acquisition cost of such ABCP plus accrued interest all ABCP purchased through the bank or its subsidiaries and held by (i) the NBC and Altamira public mutual funds and in the pooled funds used by Natcan in its discretionary management and by National Bank Trust in its private investment management; (ii) in individual retail client accounts; and (iii) by other non accredited investors who had total holdings of Cdn. $2 million or less in ABCP in their accounts with NBC or its affiliates. It was estimated at the time that the NBC commitment would represent a cash outlay of about $2 billion.

On March 4th, 2005, Manulife Financial (''Manulife'') announced that it would acquire the interest its clients held in Portus Alternative Asset Management Inc. (''Portus'') at the value of their original principal investment in Portus and that the clients would remain entitled to receive any positive return that might ultimately be earned on their Portus investments. Manulife had a referral arrangement with Portus which was totally independent and unrelated to Manulife. This decision to make its clients whole was made only a few weeks following the issuance of cease trade orders against Portus and its affiliates by the Ontario Securities Commission and well before it had sufficient information to determine the net cost of its compensation offer. At the time, it was estimated that its client's investments were valued at $246 million. The shortfall stemming from the fraud and bankruptcy of Portus was anticipated to reach at least 15% of the face value of the investments.

We recognize that a sound investor protection regime cannot rely on the expectation that the leaders of large financial institutions will always voluntary ''do the right thing''. However, it cannot either disregard the strong financial incentives that are at work in such cases. What is called for is a balanced assessment of the incentives and risks which differ considerably according to the size and public standing of the financial services firms.

The empirical evidence also shows that the features of the regulatory apparatus that govern financial services corporations, particularly those pertaining to prudential regulation, have a substantial impact on the incidence of calls on an investor compensation scheme. In the case of financial institutions and firms listed on a senior exchange, the positive effects are still more pronounced since they are subject to continuous disclosure requirements, they operate under the watchful eye of investors, analysts and the media, they are the object of regular independent credit risk ratings, and the management and directors of the corporation are liable for civil suits by shareholders for issuing misleading material information. These important additions to the regulations applicable to financial services firms and their activities are absent in the case of privately-owned firms and professionals working independently or in partnership. This distinction is particularly relevant to the analysis of the FISF since its genesis is the model adopted for the accountant and legal professional orders in Quebec rather than the approach that prevails in major jurisdictions for all segments of the financial industry.

- **Unauthorized business:** Securities regulatory authorities are mandated not only to regulate the industry but to preclude any non registered individual or firm from engaging in securities transactions with financial consumers. In our diverse and complex societies, this mandate presents challenges writ large. These difficulties are compounded because a large proportion of the financial frauds committed by non-registered persons begin as an ''affinity fraud''. Close-knit communities are particularly vulnerable to such scams because of the trust and high regard in which they hold other members of the community.

  In response, public policies have attempted to broaden and diversify the informal flows of information to the regulators. The whistleblower programs and the gradual yet unrelenting efforts to expand their scope and effectiveness are aimed at closing the information gap.

- **Diligent resolution of customer claims:** Financial consumers do not have access to their accounts during a liquidation or bankruptcy process. The long delays in identifying the assets and in determining the losses incurred by each investor in the case of failure of a financial services firm and, consequently, in returning the segregated assets to their owners is cause for much aggravation. Even if investors are made whole at the end of the process, the uncertainty in the intervening period creates a lot of anguish which inevitably reverberates on the regulators and elected officials. The OBSI reports leave no doubt that the resolution of conflicts related to investments is a complex matter. In 2010, 81,4% of the banking complaints were resolved within 180 days from receipt; for complaints related to investment matters, 67,5% were still not resolved after 180 days. This complexity is compounded in liquidation or bankruptcy cases.

  The determination of the monetary value of individual accounts in deposit taking institutions which comingle cash deposits and use the funds to finance their own activities, is singularly less complex than the allocation of assets in firms that hold (or are expected to) customer assets in investor segregated accounts. One reason for the difference lies in the legal relationship: in the case of monies held as deposits, the customers' funds are comingled with the banks' own funds and the bank is the debtor to its depositors. In the event of bankruptcy, the customer has a proportionate claim on the remaining assets. Another reason is that money is fungible; there is no need to identify which belongs to whom, simply to determine the net amount in each depositor's account.

  For securities firms and mutual fund dealers, including mutual funds, the financial services firm has a safe-keeping obligation; the customer financial assets must not be aggregated with the firm's own assets or other assets. This may be counter-intuitive but it is a fact that the proper identification of financial assets held or supposed to be held in segregated funds in the name of an investor is a complex and tedious undertaking. Moreover, bankruptcies of financial services firms resulting from fraudulent schemes engender complex insolvency law issues which cause delays in the resolution of the cases and much grief for investors. In addition, the asset untangling process is often embroiled in suits brought about by pettifogging customers and other third parties. These issues are magnified when the bankrupt firm is not registered to provide the financial services.

A policy response to these issues has been to adopt special legislative provisions governing the liquidation or bankruptcy of banks, insurance companies and securities firms. The addition, in 1997, of Part XII to the *Bankruptcy and Insolvency Act* that pertains specifically to the bankruptcy of securities firms in Canada is a case in point.

1.3 Summary

In summary, nowadays, the design of investor protection schemes must address the following issues:

- The unintended consequences stemming from the extensive regulation of capital markets and financial services firms on investor's expectations.
- The scope and extent of the investor compensation coverage.
- The inherent and structural incapacities of regulators to stamp out, ex ante, unethical behaviour, fraud and other unlawful actions arising, in large part, from their relative isolation from the financial consumers markets and industry players and the complexities of modern societies.
- The long delays in returning financial assets to their legitimate owners and in determining the extent of ''insured'' losses for each individual investor, if any, which delays inevitably occur in the liquidation of a financial services firm
- The extent of the fiduciary responsibilities vis-à-vis retail customers of the management and sales representatives of financial services firms arising from their professional status and the 'know your client' and suitability requirements.
- The rules that govern the liquidation of financial services firms under bankruptcy and insolvency laws, nationally and across jurisdictions; their interrelations with investor protection objectives and the role and status of investor compensation schemes in bankruptcy proceedings.

- The vagaries, costs and time consuming efforts associated with a regime of redress dependent on resolutions by the Courts.

The choices open to public authorities to resolve these policy issues are not neutral in their effects. Each option should be weighted against the following questions: i) to what extent will the design of the compensation system affect the incentives of financial consumers to choose their financial services firm carefully; ii) how will the compensation scheme be financed and how will the schemes' financing rules affect the behaviour of financial services firms and their senior management; iii) to what extent will the design of the compensation scheme encourage organizations less rigorous in their management processes and thinly capitalized to enter the market; iv) how will the structure of the compensation scheme and its financing affect the regulatory authorities?

The next section describe in broad terms the response of the European Community, the United States and Canadian authorities to these policy issues and the means they have mustered for the task.

II. A General Overview of Investor Compensation Schemes

The public consultation launched by the AMF is not focused on compensation schemes established to cover losses arising from the failure of deposit taking institutions, insurance companies and securities broker-dealers. The Quebec deposit insurance fund is modeled on the Canada Deposit Insurance Corporation and provides similar protection for deposits in deposit institutions under Quebec jurisdiction. With respect to insurance companies, AMF regulations require all life insurance companies and property and casualty insurance companies to be members of Assuris and of the Property and Casualty Insurance Compensation Corporation, respectively. These two organizations are the pan-Canadian compensation schemes for these segments of the financial industry. Therefore, the discussion that follows does not cover such schemes. Although not a specific object of the consultation, we, nevertheless, review the structure and workings of the securities industry Canadian Investor Protection Fund (''CIPF'') because it provides coverage for Quebec financial consumers who acquire units or shares of mutual funds through an investment dealer. Moreover, it holds many useful lessons for the matter under consideration.

2.1 Investor Compensation Schemes in the European Union

In 1989, the European Union adopted regulations for the purpose of implementing supervisory authorities in every Member State. Important areas of capital markets laws and regulations were put under the control of a national supervisory authority, a requirement reasserted in successive Directives[10].

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[10] See, for instance, Directive 2004/39/EC regarding the market for financial instruments (MiFID); the Approximation Directive 2006/31/EC; Directive 2003/71/EC regarding changes to the Prospectus Directive 2001/34/EC

In response, several Member States established comprehensive multi-functional supervisory authorities. For example, Germany established the BaFin, a combination of the Federal Securities Supervisory Office, the Federal Banking Supervisory Office and the Federal Insurance Advisory Office. Similar comprehensive financial supervisory authorities exist in Denmark with the Finanstilsynet, in Austria with the Financial Market Supervisory Authority, in Great Britain with the Financial Services Authority and in France, with the Autorité des Marchés Financiers[11]. Under the Lamfalussy Process designed to accelerate the adoption of financial regulations at the European level, legislative and regulatory activity reached stronger intensity in the direction of full harmonization. Following the recommendations of the Larosière Report, this trend culminated with the enactment, on 22 September 2010, of the European system of financial supervisors consisting of the European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational Pensions Authority.

In March 1997, the European Council adopted Directive 97/9/EC which governs the investor compensation schemes (''ICD'') in EU member states. The ICD is part of the framework for the establishment of a single market in financial services. It was modelled on the Directive 94/19/EC on deposit guarantee schemes. Based on an in-depth review of the situation and extensive consultations, the European Commission published, on July 12, 2010, a proposal to amend the existing ICD. The European Parliament issued a draft report on January 25, 2011 concerning the proposed European Commission Directive with respect to investor compensation schemes across the European Union. The report was adopted at a plenary session on July 5, 2011 (''ICSD'')[12]. It is anticipated that the ICSD in its final form will come into force sometime prior to the end of 2012. The aim of the ICSD is to protect investors against the risks of fraud, administrative malpractice, operational error and bad advice which cause the failure of an investment firm or a third party that holds, administers or manages the financial assets on their behalf. The ICSD approved by the European Parliament provides that:

- Clients receiving investment services from investment firms (including credit institutions) must be compensated in specific circumstances where the firm or third party is unable to return money or financial instruments owned by the client that it holds, manages or administers on its behalf.

- Coverage must extend to all investors which are not classified as professional, investment firms or institutional investors under the Markets in Financial Instruments Directive (''MiFID''). As a result, small-sized enterprises are generally covered[13].

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[11] These European developments have greatly influenced the policy direction for the regulation of the financial sector in Quebec. See, for instance, the Martineau report which proposed the creation of a multifunctional regulator, the AMF.

[12] Directive amending Directive 97/9/EC of the European Parliament and of the Council

[13] MiFID classifies as a professional a client who possesses the experience, knowledge and expertise to make its own investment decisions and properly assess the risks that it incurs. In particular, enterprises which meet two of the following size requirements

- All investment services and activities covered under MiFID are subject to the ICSD[14].
- The value of financial assets insured is capped at €100,000 per investor.

The scope of the protection mandated by the ICSD is extensive. The underlying principle which guided the European Parliament is that it is incumbent upon the supervisory authority to ensure that all entities providing investment services are duly registered and compliant and that it is a legitimate assumption for retail investors to assume that they are covered by the investor compensation scheme without checking the detailed conditions on a firm's authorization[15]. Accordingly, the ICSD also provides that:

- Investors must be covered for claims relating to the failure of an investment firm to return financial instruments to an investor due to the failure or default of a third party custodian. Investment firms remain responsible to take all reasonable steps to recover assets from a custodian. As a result, the level of protection provided for investors is the same irrespective of how financial instruments or money held on a client's behalf is held by the firm itself or by a third-party custodian selected by the firm.
- If a firm *de facto* holds, administers or manages client assets, then the clients are entitled to compensation. This is irrespective of whether the firm is doing so in breach of any limitation on its authorization (e.g. preventing it from holding client assets or from dealing with retail clients) or lacking such authorization and irrespective of the nature of the MiFID investment service it provides.

The policy issue of the delay in resolving investor compensation cases is addressed in the ICSD. It specifically recognizes that in the case of compensation schemes, the underlying situations of fraud, malpractices or operational problems covered by the Directive make a longer delay necessary in order to reconstruct the position of single investors[16]. Accordingly, whereas in the case of deposit guarantees, depositors must be repaid within twenty working days of the date on which authorities make their determination of the inability of a credit institution to repay the deposits, **investor compensation schemes must reimburse investors within 90 working days of**

on a company basis: (i) balance sheet total: EUR 20 million; (ii) net turnover: EUR 40 million; (iii) own funds: EUR 2 million, are deemed to be a ''professional''.

[14] The MiFID list includes an extensive range of investment services and activities and ancillary services related to a comprehensive definition of financial instruments, including units in collective investment undertakings.

[15] The amendment to the text proposed by the Commission adopted by the European Commission is unambiguous with respect to the legislative intent: ''(5) Investors may not be aware of ***lacking or limited authorisations*** of investment ***firms***, thus it is necessary to protect them in situations in which investment firms act ***without, or*** in breach of, their authorisation notably by holding client assets or providing services to a particular type of client ***without, or*** contrary to, the conditions of their authorisation. Therefore, schemes should cover clients' assets which are de facto held by investment firms in connection with any investment business.'' (Source: European Parliament legislative resolution of 5 July 2011).

[16] EC.COM (2010) 371 final

the date where the eligibility and the amount of the claim have been established. The procedures necessary to establish the eligibility and the amount of a compensation claim depend on national administrative and insolvency laws.

To ease the burden on retail investors, the ICSD requires compensation schemes to provisionally pay partial compensation based on an initial assessment of the claim, if the payout delay exceeds a specified time period. The level of the partial payment should amount to one third of the initial assessment of the claim, the balance to be paid out later once the claim had been fully verified. Schemes have the ability to recover amounts provisionally paid out if it was subsequently determined that the claim was not valid.

Moreover, schemes making payments to compensate investors for failure of a depositary or a third party have the right of subrogation to the rights of the investors against the investment firm in liquidation for amounts equal to their payments. This provision is necessary to allow a scheme to recover the funds paid for compensation. This provision does not diminish the responsibility of investment firms to recover assets from a depositary or custodian.

The ICSD imposes a duty on investment firms to inform investors. In particular, they are required to:

- Make available to actual and potential investors information about the relevant investor compensation scheme including the amount and scope of cover. The information must be made available in a readily comprehensible manner.

- Disclose to investors in clear and simple terms what is effectively covered by the investor compensation scheme and they must also explain how it applies in cross border situations and clearly explain that losses arising from changes in the market value of the financial assets are not subject to the payment of compensation.

With respect to the funding of the investor compensation schemes, the ICSD specifies three basic principles:

- The cost of financing schemes should be borne by market participants;

- The schemes should be adequately financed in proportion to their potential liabilities;

- In order to provide a sufficient level of funding to deal with contingencies, a minimum target fund level must be established for all schemes. This target fund level must be fully funded within a 10-year period.

2.1.1 Investor compensation with respect to ''Undertakings for Collective Investment in Transferable Securities'' (''UCITS'')

UCITS are open-ended funds investing in transferable securities and, within the constraints established by EU Directives, in other investment vehicles or strategies. They are the dominant type of regulated European retail funds.

The custody of UCITS is not a MiFID investment service. As a result, the ICSD would not cover UCITS and their units' holders in cases where losses would be suffered due to the failure of a UCITS depositary or sub-custodian. The European Commission argued that this situation was comparable, in substance, to the one where losses are suffered due to the failure of an investment firm custodian or sub-custodian. Accordingly, the initial legislative proposal gave UCITS holders the right to be compensated by the investor compensation scheme if the assets could not be returned because of the failure of a UCITS depositary or sub-custodian. The cost of this extension in coverage would have been borne by these entities rather than investment firms.

The European Parliament decided to exclude UCITS depositaries and sub-custodians from the application of the ICSD as they considered that they are sufficiently covered by other legislation. Indeed, the regulation of UCITS has been and continues to evolve through several iterations. The first UCITS Directive was adopted in 1985; it was substantially amended in January 2002 by two main Directives, the Management Directive and the Product Directive (UCITS III) and, then again, in 2009 (UCITS IV)[17].

The regulations impose structural requirements. Directive 2009/65/EC requires UICTS assets to be safe kept by a depositary. A UCITS fund must always appoint a custodian, an administrator and an auditor; each regulated in the jurisdiction of the UCITS fund. Depending on the structure, it may also appoint a management company or be governed by individuals (if incorporated under the form of a self managed UICTS fund). The custodian and the management company are controlling agents and are required to monitor the activities of the ICITS fund. **They are directly responsible to investors, irrespective of whether or not they have delegated their duties.** The management company must not delegate its functions to the extent that it would actually become a ''letter box'' company. The custodian also has strict custody requirements, and non-cash assets of a UCITS fund must be segregated.

A custodian cannot act as a management company and custodian to the same fund. It can act solely as custodian and may also assume the role of administrator. The administrator's responsibilities entail the determination of the net asset value of the UCITS fund, the management of the shareholder's register and acting as transfer agent. Both the administrator

[17] Namely, Council Directive 85/611/EEC of 20 December 1985; Directive 2001/107/EC of 21 January 2002; Directive 2001/108/EC of 21 January 2002; Directive 2009/65/EC and Council Directive 3605/1/09 of 22 June 2009.

and the custodian are independent entities and they must be authorized by the EU Member State to perform these functions. The management company is the entity which has the ultimate responsibility for the management of the fund and its investments. The promoter of a UCITS fund offers an additional financial guarantee to investors for the actions of the management company and the UCITS fund. The minimum capital obligations required to act as a promoter of a UCITS fund is not set in EU law but Member States must ensure that the level is sufficient to provide added asset protection for the ultimate investors.

On July 1st, 2010, Commission Directive 2010/43/EU which applies to management companies pursuing the activity of management of UCITS and to depositaries holding the assets in which the UCITS are invested came into force. The Commission Directive imposes on the management companies the duty to act in the best interests of the UCITS when executing decisions on behalf of the UCITS they manage. It covers comprehensively matters concerning organisational requirements, conflicts of interest, conduct of business, risk management and the content of the agreement between a depositary and a management company[18].

A lingering question remains: is the current legislation enough to protect investors? Consultations are underway with regards to further amendments (UCITS V) which would strengthen the role of depositaries by (i) expanding their oversight responsibilities; (ii) increasing their liability; (iii) giving all UCITS investors the right to sue depositaries, either directly or indirectly, through the management company; and (iv) by shifting the burden of the proof onto the depositary for negligence or intentional failure to perform its duties.

The proposed changes would see that in addition to safekeeping assets, depositaries would be required to ensure that all transactions (i.e. subscriptions, redemptions and cancellations of units) affected by or on behold of UCITS funds are carried out in accordance with the law and the fund documentation. Crucially, depositaries must act independently and solely in the interest of the unitholders to effectively discharge this role.

The new rules would require UCITS to appoint a single depositary entrusted with the task of safekeeping all the fund's assets. The depositary must be in a position to have oversight and responsibility for all assets and cash transactions for the fund. The depositary would be required to perform independent controls over how the UCITS is managed on a regular basis

2.2 Investor Compensation Schemes in the United States

The system in the United States to compensate investors for losses resulting from the failure of a securities firm or from securities fraud is best characterized as a three-pronged approach. The first takes the form of a Federal securities investor compensation scheme, the Securities

[18] In many respects, the Directive is substantially to the same effect as National Instrument 31-103, ''Registration Requirements, Exemptions and Ongoing Registrant Obligations''

Investor Protection Corporation (''SIPC''). Its purpose is to provide protection against loss to customers resulting from the failure of a securities firm.

The second strand empowers the Securities and Exchange Commission SEC to compensate investors injured by securities fraud through the use of a Federal Account for Investor Restriction Fraud (''Fair Fund''). Fair Funds are established on a case by case basis. The sums available for compensation are obtained through disgorgement by the parties in violation of securities law and the monetary penalties levied through SEC administrative proceedings with respect to each case. Hence, the assertion that ''insurance for investment fraud does not exist in the US'' may be technically accurate but fails to recognize that another powerful and effective mechanism exists to protect individual investors from malevolent conduct by securities broker-dealers and issuers.

The third mechanism is under the jurisdiction of the states and relies almost exclusively on redress through the Courts.

2.2.1 The Securities Investor Protection Corporation

SIPC was established in 1970 with the adoption of Securities Investor Protection Act (''SIPA''). SIPC is constituted as a nongovernmental, non-profit private membership corporation. As a general rule, all SEC registered brokers and dealers and members of a national securities exchange are members of SIPC[19].

The paramount objectives of SIPA and of SIPC, its operating arm, are to protect investor assets held by SEC registered broker-dealers in cases of financial failures and to provide protection against loss to customers in such an event. SIPA defines a ''customer'' as a person who has deposited cash with the SIPC member for the purpose of purchasing securities. In practice, SIPA is considered, in most material respects, as if it was a section of the Securities Exchange Act of 1934.

Upon SIPC being advised by either the SEC or an SRO that a broker or dealer (subject to their regulation) is approaching financial difficulty or breaching capital requirement rules, SIPC must inform the firm and file with any Court of competent jurisdiction an application for a protective decree and the appointment of a trustee.

[19] The following categories of securities/investment firms are excluded from SIPC membership

- Persons whose principal business is conducted outside the U.S.
- Persons whose business as a broker or dealer consists exclusively of :
  i. Distribution of shares of registered open end investment companies or unit investment trusts
  ii. Sales of variable annuities
  iii. The business of insurance
  iv. The business of rendering investment advisory services to registered investment companies or insurance companies separate accounts

Pending issuance of the decree, the Court has: (i) exclusive jurisdiction over the debtor and its property; (ii) exclusive jurisdiction over any suit against the trustee with respect to a liquidation; (iii) the powers and duties conferred upon it by SIPA and Chapter 11 of the *''U.S. Bankruptcy Code''* (''Code''). The Court also stays any bankruptcy, mortgage foreclosure, equity receivership or other proceedings of same nature (reorganization, etc.) and may stay any proceeding to enforce a lien against property or any other suit against the debtor.

The ''SIPC'' trustee is vested with the same powers and title with the debtor and the property of the debtor as a bankruptcy trustee. Although, substantial portions of the Code apply to SIPA liquidation proceedings, its main purpose, contrary to the aim of Chapter 11 of the Code, is not to assist owners rehabilitate the firm but to effect its orderly liquidation[20]. The Act is unambiguous: the purpose of these bankruptcy proceedings are:

> ''1. As promptly as possible after the appointment of a trustee in such liquidation proceeding, and in accordance with the provisions of this Act
>
> a) To deliver customer name securities to or on behalf of the customers of the debtor entitled thereto as provided in section 8(2); and
>
> b) To distribute customer property and (in advance thereof or concurrently therewith) otherwise satisfy net equity claims of customers to the extent provided in this section;
>
> 2. To sell or transfer offices and other productive units of the business of the debtor
>
> 3. To enforce rights of subrogation as provided in this Act
>
> 4. To liquidate the business of the debtor[21]''

Moreover, without customers' consent, the SIPA trustee, subject to SIPC prior approval, may sell or otherwise transfer to another member of SIPC the customer accounts of the defaulting member.

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[20] There is a fundamental difference in orientation between the two proceedings. There is a statutory grant of authority to an SIPC trustee to purchase securities to satisfy customer net equity claims to specified securities. The trustee is required to return customer name securities to customers of the debtor, distribute the fund of ''customer property'' ratably to customers and pay, with money from the SIPC fund, remaining customer net equity claims, to the extent provided by the Act. A trustee operating under the Code lacks similar resources. The Code seeks to protect the filling date value of a customer's securities account by liquidating all non-customer name securities. SIPA seeks to preserve an investor's portfolio as it took on the filling date. Under SIPA, the customer will receive securities whenever possible.

[21] SIPA, Section 6

In the event of the refusal of SIPC to commit its funds or otherwise act for the protection of customers of any member of SIPC, the SEC may apply to a Federal District court for an Order requiring SIPC to discharge its obligations or for such other relief as the Court may deem appropriate[22].

The level of protection provided by SIPC is set at $500 000 for a securities claim and at $250 000 if the claim is for cash. In accordance with SIPA, all the proceeds recovered through asset forfeiture settlements or other means are paid to the financial customers up to the ''net equity value'' of their assets at the ''effective date''. SIPC assumes all the accounting, legal, trustee and associated costs incurred to liquidate a brokerage firm and resolve customer claims.

The courts have focused on the substance of the transactions rather than their form. Accordingly, the jurisprudence holds that an investor may be deemed to have deposited cash with the registered broker-dealer for the purpose of purchasing securities – and thus be a covered customer – even if the investor initially deposited those funds with an entity other than the broker-dealer. Otherwise, SIPC is not required to cover losses resulting from the failure of an entity which is not an SEC registered broker-dealer or member of a national securities exchange. In the case of the Madoff's swindle, the SIPC Board stretched their definitions: a) to cover all transactions transiting through the brokerage firm, Madoff Investment Securities, even though the fraud was conducted by the registered investment advisor arm, which was not a member of SIPC and, b) to treat all claims as a claim for securities, not cash.

In order to mitigate the impact of the delays on customers in resolving bankruptcy cases, SIPC makes advanced payments to cover investor losses upon notice from the trustee of determination of a claim. They are not always trivial amounts: SIPC net advances in the Madoff case to carry out its statutory obligation to satisfy customer claims and to pay administration expenses amounted to $1.06 billion.

Another approach used by SIPC to accelerate compensation payments is the out-of-court Direct Payment Procedure where it determines that it will be less onerous than bankruptcy proceedings and (i) the broker-dealer has insufficient assets on hand to reimburse the cash/securities owned by its customers; (ii) all customers are owe less than $250,000; (iii) the claim of each customer is no more than the limits of SIPC advances[23].

With respect to communications with investors, substantial information material on the coverage provided by SIPC is available and generally made available to financial consumers by

[22] One such case, the Stanford case, is presently pending before the courts. SEC claims that SPIC should compensate some Stanford victims even though their funds were held by a foreign bank, since it was controlled by Stanford. Thus far, SPIC has declined coverage.

[23] SIPC has also established an ''hardship'' program aimed at accelerating advanced payments to investors severely distressed by the delay in returning the assets and paying compensation.

broker-dealers. Worthy of note, false assertion of protection under SIPA (i.e.SIPC membership) is subject to criminal penalties.

Concerns about the adequacy of information provided to investors about SIPC policies and practices and financial consumers' responsibilities to protect their investments has been a recurrent theme and the topic of several reports. In response, the SEC and SIPC have implemented measures to increase investor awareness of SIPC's policies. These includes, for instance, inclusion in the SIPC brochure and Web site of an advice to investors that they should complain in writing to their securities firms about suspected unauthorized trades, a discussion of market risk and SIPC coverage and a requirement that firms that display an expanded statement about SIPC must include a reference or link to SIPC's Web site. Moreover, SEC, the NASD, and many securities firms provide the recommended disclosures about the scope of SIPC coverage to investors on their Web sites. SIPC also added links to Web sites in its brochure that offer information about investment fraud. Moreover, the SEC requires registered non-member broker-dealers and affiliates to disclose their non-SIPC status.

The funding of SIPC is achieved through levies on its members. SIPC is currently collecting assessments on its members based upon 0.25% of each member's net operating revenues from the securities business. As of December 31, 2010, the Fund stood at $1.2 billion; the capitalization target has been set at $2.5 billion.

SIPC is authorized to borrow in order to meet eligible customer claims obligations. The SEC may extend loans to SIPC where it determines that such loans are necessary for the protection of customers of brokers or dealers and the maintenance of confidence in the US securities markets. It currently has statutory authority to lend up to $2.5 billion.

2.2.2 Additional Customers Protection

In order to protect customers from potential losses in excess of the SIPC protection limits, some major investment firms have purchased Excess SIPC insurance coverage. It must be noted that since its inception in 1971, the total value of the unsatisfied portion of claims not covered by SIPC amounted to $47.2 million (351 claims out of 625,100). An important feature of the excess insurance coverage is that there is no commitment to pay on a claim until all assets of the defunct firm have been marshalled and distributed, a process that generally takes a lot of time.

2.2.3 Fair Funds

The US federal legislative history demonstrates a gradual but clear recognition that private recourse to the courts by injured financial consumers seeking compensation for financial losses caused by fraudulent or other unlawful actions by a securities firm or an issuer and their related parties is an inadequate and ineffective policy, unable to ensure reasonable investor protection and maintain confidence in capital markets and financial institutions. The direct involvement of a regulatory agency is required to secure redress and achieve the overarching objective of investor protection in a timely manner, at reasonable costs. This direct involvement by public authorities is also required to restore the balance between the resources available to individual investors to marshal their case and those that corporations can generally harness. Accordingly, Congress has systematically expanded over the years the means available to the SEC to compensate investors for losses stemming from securities fraud and other unlawful actions. A significant step was the establishment under the Sarbanes-Oxley Act of 2001 (''SOX'') of the Fair Fund program. This program was further expanded under the Dodd-Frank Act. Since 2002, more than $9.5 billion in Fair Funds were ordered.

Table 1 shows the major milestones in the evolution of the law.

Table 1
Synthesis of the Fair Funds Legislative History

Year	**Legislation**	**Scope**
1970s	-	''The primary function of the SEC is to protect the public from fraudulent and other unlawful practices and not to obtain damages for injured individuals''
1990	The Securities Enforcement Remedies and Penny Stock Reform Act	Gave the SEC authority to seek disgorgement in administrative proceedings and to remit all disgorgement funds to injured investors. It also expanded its penalty authority to reach most violators of securities laws but such penalties had to be remitted to U.S. Treasury
1990s	Courts begin to ascertain their equitable power to grant the ancillary relief of disgorgement as a means to deprive defendants of their illicit profits	
2002	Sarbanes-Oxley Act. It established the Federal Account for Investor Restitution Funds (''Fair Funds)	It allowed certain penalties paid in enforcement actions to be added to disgorgement funds and paid to injured investors
2011	Dodd-Frank Street Reform and Consumer Protection Act	Eliminated the restrictions contained in SOX to ensure that all penalties related to a case could be added to disgorgement funds

2.2.4 The Role of the States

In the United States, the states play a substantial role in ensuring compliance with securities laws and regulations, financial consumers' protection and enforcement. For instance, in the 2002-04 period, the data shows that the SEC accounted for only 17.6% of total public enforcement actions compared to 40.8% for the state securities regulators.

Blue Sky States rely on court proceedings to obtain conviction in cases of securities fraud and settlement agreements with defendants in order to secure compensation for injured investors. For instance, in New York State, the Martin Act gives the Attorney General broad law enforcement powers to conduct public and private investigations of suspected fraud in the offer, sale or purchase of securities and, at its discretion, commence civil and criminal prosecutions to protect investors.

The jurisdiction of state securities commissions to investigate and bring enforcement actions with respect to fraud, deceit or unlawful conduct in connection with securities transactions was explicitly preserved under the National Securities Markets Improvement Act of 1996 (''NSMIA''). The Dodd-Frank Act did not only confirm the jurisdiction of the states under NSMIA; it expanded the investor protection and enforcement roles of state securities regulators. In particular, the Act increased state regulatory authority over investment advisors having assets under management from \$25 to \$100 million. It is estimated that, as a result, about 4,000 investment advisers will switch from SEC to state registration.

2.3 Investor Protection Schemes in Canada

Three Canadian investor protection schemes are directly relevant to the topic of the AMF consultation exercise. The first, the Canadian Investor Protection Fund (''CIPF''), covers registered securities brokers and investment dealers across Canada. Financial consumers of mutual funds which are clients of an investment dealer in Canada are covered by CIPF. The second, the MFDA Investor Protection Corporation (''IPC''), covers mutual fund dealers in all provinces and territories, except in Quebec. The third, the Fonds d'indemnisation des services financiers (''FISF''), is a compensation system for victims of fraud committed by a representative or firm duly certified by the AMF in a sector covered by the FISF. It is limited to Quebec.

2.3.1 The Canadian Investor Protection Fund

CIPF is a securities industry sponsored not-for-profit private corporation established to compensate customers in cases where a registered securities broker-dealer member of the Investment Industry Regulatory Organization of Canada (IIROC) becomes insolvent. Membership in IIROC and CIPF is mandatory for securities broker-dealers registered with a securities regulator in Canada.

Financial consumers are covered for losses incurred as a result of the failure of the CIPF member to return or account for securities, cash balances, commodities, futures contracts, segregated insurance funds or other property, received, acquired or held by, or in the control of, the member for the customer, including property unlawfully converted. In determining the coverage, CIPF distinguishes general accounts from separate retirement accounts. The maximum coverage for eligible financial losses for each category of accounts is set at \$ 1 million. Since 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.

Losses arising from changes in the market value of financial assets are not covered. Moreover, financial consumers are covered only if they deal with a registered securities firm. In other cases, CIPF coverage would not apply. Financial institutions and firms and the related parties to the firm in default are excluded from coverage.

The *Bankruptcy and Insolvency Act of Canada* was amended in 1997 to include provisions specific to the bankruptcy and ensuing liquidation of dealers in securities and clearing houses. These provisions, akin to those found in SIPA, give precedence to the interests of financial consumers over other claimants in the liquidation or bankruptcy of a broker or dealer in securities. CIPF is recognized as a *''customer compensation body''* under the Act; in several respects, it fulfills a role equivalent to that of SIPC in the United.

The determination of the amount and validity of a financial consumer's claim and the calculation of the financial losses eligible for compensation is performed by the appointed trustee in bankruptcy or the court appointed receiver. The following rules are applied to determine the eligible financial loss of each financial consumer:

- The date of bankruptcy of the member or the date of suspension of the securities firm's registration by a securities commission or by a recognized exchange because of a breach of capital adequacy rules is deemed the relevant date, whichever is the earliest, for indemnification purposes.

- The amount of securities delivered to a customer in satisfaction of a claim is the amount to which the consumer was entitled as at the relevant date net of any other compensation, without regard to subsequent market fluctuations.

- Where the securities are not available to be delivered, cash in an amount equal to their value as at the relevant date may be paid to the customer even though the amount of such cash may not be equal to the value of such securities as at the date of payment.

- Open positions in a client's account may, with or without notice, be closed out or liquidated pursuant to the terms of the account with the member or correspondent broker, clearing house or exchange requirements or applicable insolvency legislation or orders.

The CIPF coverage policy is uncommittal with respect to the time of payment following the determination of the claim by the trustee.

The CIPF is funded by member firms through an assessment based on revenues and a risk weighting assessment of each member firm. The risk factors include the strength of internal controls, profitability and capital adequacy, as determined by IIROC. Payments to CIPF are collected by IIROC and remitted quarterly.

As at December 31st, 2010, the assets available in the Fund stood at $382 million. In addition, CIPF is insured in the amount of $116 million for any one loss and in the annual aggregate should CIPF have to pay in excess of $100 million, and it has established lines of credit with two Canadian banks totalling $100 million. IIROC has guaranteed these lines of credit by pledging its ability to assess members.

CIPF has given considerable attention to the assessment and mitigation of the risks inherent to its ''business''. The risk weighting formulae for the determination of the premium paid by each member firm is uncommon. The adoption of an extended whistleblower policy which provides that, in addition to employees, other persons can report to the Chair of CIPF's Audit Committee, confidentially and anonymously, any financial complaint or concern regarding questionable accounting or auditing matters relating to CIPF is worthy of note.

2.3.2 The MFDA Investor Protection Corporation

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''), the SRO for all registered mutual fund dealers active in all parts of Canada, except for those which limit their activities to Quebec. Members of the MFDA are required to be member of IPC. 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. Although MFDA is not recognized as an SRO by the AMF, they have entered into a co-operative regulatory agreement which allows MFDA to exercise its authority with respect to its members' affairs in Quebec regarding prudential regulation.[24].

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. Since MFDA is not recognised by the AMF, Quebec customers of mutual fund dealers are not covered by IPC. Financial institutions and firms and related parties to a member are also excluded from coverage.

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 a MFDA member for

[24] The recognized SRO for mutual fund dealers and Approved Persons is the Chambre de la sécurité financière.

the account of a customer at the effective date of its 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.

Mutual fund dealers are deemed ''securities firms'' under the *Bankruptcy and Insolvency Act*. In line with the recommendation of the Working Group established by the IPC Board of Directors tabled in September 2006, IPC was recognized on March 25, 2011, as a *customer compensation body* and, therefore, now benefits from the special provisions of Part XII of the Act.

2.3.3 The Fonds d'indemnisation des services financiers (''FISF'')

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. 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. Even though its assets are kept separate from other AMF assets, the FISF is an intrinsic part of AMF, not a distinct corporate entity.

The purpose of the FISF is to indemnify victims of fraud, fraudulent tactics or embezzlement committed by a firm, an independent representative or an independent partnership registered under the DFPS Act or a mutual fund dealer or scholarship plan dealer registered under the *Quebec Securities Act*[25]. It is an investor compensation scheme established for the limited purpose of indemnifying fraud related losses caused by a registered entity or representative acting within the boundaries of their registration.

The maximum compensation payable by the FISF is $200,000 per claim. The AMF assumes the cost 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 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);
- 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.

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[26]. 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 ICST. Nevertheless, 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

[25] FISF covers the fraudulent actions carried out by 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.

[26] 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).

coverage under the Compensation Fund is limited and misunderstood, since it varies depending on the intermediary's registration category and the product offered.''[27]

FISF excludes from coverage losses resulting from the bankruptcy of a covered registered market intermediary 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 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 (i.e. IPC or FISF).

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.

III. THE PERVASIVE INFLUENCE OF BANKRUPTCY AND INSOLVENCY LAW

The determination of the financial assets owned by financial consumers and the shortfall in the value of such assets, if any, under the management of a financial services firm which becomes insolvent immediately brings to the fore the legal constraints that govern bankruptcy proceedings and their – often uneasy – interplay with investor compensation schemes. This applies in all jurisdictions; Canada is no exception.

In Canada, bankruptcy and insolvency is a legislative competence of the federal Parliament[28]. 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 myriads 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 potentially volatile securities whose value could plummet while customers battled over their entitlement to these assets.

Part XII creates three distinct baskets of financial assets:

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

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

- 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 effected 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 not 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

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

Two court decisions pertaining to the application of the Act are particularly relevant to the mutual funds industry. In Farm Mutual Financial Services (''FMFS''), the Court established that the purchase of the fund units, the confirmation of same and the recording of their interest in each of the funds register and in the transaction summaries of the monthly statements delivered to unitholders constitutes evidence that unitholders have clearly ascertainable legal and equitable rights in the portfolio assets and the funds units. Therefore, neither the portfolio assets nor the pooled funds units were owned or held by FMFS and they could not have vested and did not vest in the trustee. Note that ''held'' means possession rather than control. As stated in the Portus decision, section 261 of the *Bankruptcy and Insolvency Act* should be construed in such a way that ***form does not triumph over substance***. In a nutshell, units of a mutual fund are securities in their own right and must be treated accordingly.

With respect to the assets to be segregated in a Customer pool fund, it is now established that all the cash and securities held by a securities firm at the date of bankruptcy vest in the trustee, not just the cash or securities beneficially owned by the securities firm. The only securities excluded from the *pool* are the Customer name securities.

The definition of *securities firm* 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[29].

Two other important features of Part XII of the *Bankruptcy and Insolvency 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.

The FISF is neither an insolvency protection insurance program nor a corporate entity. 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 administration of a bankruptcy estate by designating an inspector and be consulted by the trustee in bankruptcy**.

This ''special'' status is important in complex bankruptcy proceedings. Several recent cases were Ponzi schemes where the returns paid to investors as bogus investment earnings or the redemption of the investment are funded by the embezzlement of the investments made by other investors. This gives rise to numerous intricate problems. Under 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[30]. 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 same effect are generally available under other provincial statutes[31].

The decisions of the trustee in bankruptcy are determinant for the fair treatment of investors. For instance, how should the ''net equity value'' of each financial consumer be determined in a Ponzi case? The equitable rule is that the cash payments (e.g.cash in and cash out) are the

[29] 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*

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

[31] The expression ''fraudulent conveyance'' or ''payment'' refers to the nature of the payment (i.e. made with stolen funds) and not to the intent of the payee.

determinant factors, a treatment that inevitably spurs litigation from aggrieved investors. In the words of the U.S. Second Circuit Court of Appeal decision in the New Times case ''Treating…fictitious paper profits as within the ambit of the customers' ''legitimate expectations'' would lead to the absurdity of ''duped'' investors reaping windfalls as a result of fraudulent promises made on fake securities[32].'' 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.

3.1 Time is of the essence

The interdependencies between investor compensation schemes and bankruptcy and insolvency laws are critical to the resolution of the cases and the performance of the schemes. In particular, 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. This hard lesson has been taken into account in bankruptcy laws. It constitutes the *modus operandi* of experienced investor compensation organizations, a critical factor that is helped by their private corporation status and their privileged position in bankruptcy proceedings.

In Canada, the legislation dealing with the bankruptcy of banks, federally incorporated insurance companies and securities broker-dealers give broad and immediate control to the regulators to take control of the proprietary assets and those under administration by the firm to effect orderly liquidation in cases where the firms do not meet established capital thresholds[33]. 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.

[32] U.S. Second Circuit Court of Appeal, 463F.3d 125, 130 (2006)

[33] *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).

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[34]. 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*. No one disputes the fact that the delays in effecting the settlement of the Norbourg case have nothing to be commended.

The AMF is not without tools to deal with such a situation. 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 Quebec Superior Court under the *Act Respecting the Autorité des marchés financiers*[35]. 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[36]. Although this may cover a situation that is circumscribe to Quebec, it does not limit initiatives on the part of the principals of the delinquent firm in the 10 days notice period prior to the appointment of the receiver nor does it give financial consumers priority over other creditors as provided in federal legislation. More importantly, it fails to provide comforting answers to the question ''what if'' the operations of the failed firm were mainly outside Quebec?

Current regulations allow a mutual fund to invest in another fund. A feeder/master fund arrangement raises interesting questions which are clearly outside the purview of a liquidator. For instance, in the event of the failure of the master fund organization, should the feeder fund be considered has a single investor or should the financial consumers which have invested in the feeder fund be considered as individual unitholders or shareholders of the master fund? Assuming the feeder fund is Quebec-based and the master fund managed in another jurisdiction, the dissipation in the asset value in the feeder fund would not be caused by

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

[35] 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.

[36] 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.

fraudulent actions on the part of the feeder mutual fund dealer. How would FISF treat the financial consumers harmed by the demise of the master fund organization? And what protection would FISF provide if that situation caused the failure of the feeder mutual fund dealer?

Quebec financial consumers are short-changed in their level of protection by a regime that does not reflect the facts that a significant part of the mutual fund industry active in Quebec is domiciled in other jurisdictions and that bankruptcy proceedings are becoming singularly more complex. This concern does not arise solely because of the volume of business these firms conduct in Quebec but, more importantly, because the larger level 4 mutual fund dealers hold client assets, other than cash, in nominee name.

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. Contrary to the other Canadian investor compensation schemes, FISF is not recognized as a *customer compensation body* under the *Bankruptcy and Insolvency Act*. 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 a mutual fund dealer bankruptcy.

IV. OBSERVATIONS ON THE QUEBEC APPROACH TO INVESTOR COMPENSATION RELATED TO MUTUAL FUNDS

Contrary to investor compensation schemes in all other jurisdictions, the FISF does not compensate financial consumers in the case of the failure of a registered mutual fund dealer unless it is the result of fraud, embezzlement, theft and other forms of misappropriation committed against Quebec financial consumers. FISF compensates financial consumers for the dissipation of financial assets caused by fraud whether or not the registered dealer or representative is insolvent.

This peculiar approach adopted by the Quebec Government for the regulation of mutual fund dealers and the FISF stems from a rationale which was heavily borrowed from the compensation schemes adopted by the accountant and lawyer professional orders in Quebec to protect clients who have deposited moneys that the professionals must hold in trust. Accordingly, the organizing principles of the architecture of the regime aimed at protecting Quebec financial consumers dealing with mutual fund dealers 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 an agent. This approach is seriously at odds with the structure and functioning of the industry.

The mutual fund business in Europe and North America, is an industry of sizeable proportions. Mutual fund firms run the gamut from very large to very small. In Canada, as of June 30, 2011, 53 of the 132 members of MFDA had 10 Approved Persons or less; 41 had more than 100 Approved Persons of which 17 had over 1,000 Approved Persons.

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. In fact, about 90% of the representatives in Quebec are employed or agents of large financial institutions or corporations. **Clearly, an investor compensation scheme centered on representatives is misaligned with the structure and workings of the industry.**

4.1 A Risk Assessment Overview

Financial consumers are exposed to a range of risks when engaging a financial services firm to carry out investment services on their behalf. First, they are exposed to losses from a range of operational failures in the handling of their funds or management of their investments. Such mistakes are frequent but tend to be of limited impact for financial consumers. For instance, the Financial Ombudsman Service in the United Kingdom reports that 30% of the complaints concerning investment services and products pertain to administrative issues. Second, financial consumers are exposed to the risk of losses arising from inappropriate and negligent investment advice.

Third, financial consumers are subject to financial risks in the event of the default of the financial services firm. Although a low-probability risk, the impact of a default can be significant if the consumers' assets are not properly segregated from those of the firm in default. Segregation errors may arise from negligence or system failures. If assets are segregated and held with a third party, another source of low-probability but potentially high-impact risk is that of the default of the third party.

Fourth, financial consumers are exposed to the risks of theft, embezzlement or other fraudulent misappropriation of assets. The consequences can be very costly if such frauds result in the insolvency of the firm and assets are not properly segregated.

Table 2 provides a summary of the main types of risks to which financial consumers may be exposed, distinguishing between financial and operational risks.

Table 2
Classification of risks

MAIN TYPES OF RISK	DESCRIPTION
Financial risks	
Firm default	The risk that, in the event of a default by the firm, customer assets are treated as part of the assets of the defaulting entity rather than belonging to customers. Firm default may also impose costs to customers in terms of disruption and inconvenience.
Third-party default	The risk of customer asset losses in the event of a default by a third party. The third party may be a custodian institution that holds customer accounts, or an intermediate broker, clearing house or other party to which the firm transfers customer funds for transaction purposes
Operation risks	
Theft or embezzlement	The risk of customer assets being stolen or otherwise misappropriated by employees or managers of the firm or third party
Fraud	The risk of an unauthorised transfer or fraudulent use of customer assets (eg, to cover own-account trading losses), or other dishonest behaviour conducted by employees or managers of the firm or third party
Segregation error	The risk that customer assets are incorrectly identified as firm assets rather than customer assets, or vice versa
Settlement error	The risk that there is a mismatch between delivery of securities and payment of customer funds
Reconciliation error	The risk that the firm is unable to reconcile customer balances in its own internal records with those in the reports of third parties
Accounting or record-keeping error	The risk that, due to recording problems, the firm is unable to allocate customer assets to individual customers
Failure to execute (or other breaches of) client instructions	The risk of losses arising from a firm's failure to execute a customer's transaction on time or in the correct manner or to otherwise breach instructions
Other poor investment management	The risk of churning, mispricing, corporate action failures, stocklending failures, etc
Bad investment advice	The risk of receiving negligent financial advice (eg, advice without a reasonable basis)

The empirical evidence leads to a number of relevant conclusions[37]:

- Risks to financial consumers' assets differ widely in terms of impact and probability. Risks that have a high impact in terms of potential customer losses have a low probability of occurrence. In contrast, high-frequency risks tend to have a lower financial impact.

- Financial risks associated with insolvency can lead to potentially large financial consumers losses, but these risks occur infrequently. As a rule, financial services firms have to segregate client assets from firm assets and, as in the case of mutual funds, generally hold the assets in trust with a third party depositary. The default of the third party, particularly when it is a ''related'' party within a financial conglomerate, is therefore the risk with the largest potential impact – larger than the default of the investment firm itself.

- Despite the segregation requirements, several cases were observed where the default of the financial services firm itself resulted in consumer losses. **These losses mainly occurred in smaller and poorly capitalised firms**. In these cases, losses arose because insufficient funds had been segregated or because the poor record-keeping and control system of the firm resulted in a lengthy and difficult process to allocate and distribute funds to the financial consumers.

- Operational risks have a higher probability of occurrence than default risks, with settlement and segregation errors ranked as the most frequent risks. In general, such operational risks do not lead to customer losses because the operational issues are either resolved quickly by firms before any losses are incurred or, if losses did occur, they are covered by the firms. However, if severe, operational failures can trigger a bankruptcy and do exacerbate the impact. Hence, the robustness of the capital structure of financial services firms is critical to financial consumers' protection. This explains why the incidence of failure caused by operational shortcomings is much higher for smaller firms.Breaches in conforming to the restrictions associated with the registration status of the firm heightens considerably the risks of failure. There have been instances where firms handled customer cash and securities although they were not permitted by the regulator to do so. **This type of breach against regulation has principally been observed among smaller independent firms, most of which are not permitted to hold customer assets**. There have also been instances of customer cash or securities misappropriation (fraud of theft of customer assets by employees or principals of

[37] Biais, B., Casamatta, C. and Rochet, J.C. (2003). ''Operational Risk and Capital Requirements in the European Investment Fund Industry'', a report prepared for the Fédération Européenne des Fonds et Sociétés d'Investissement; BIS (2003), ''The 2002 Loss Data Collection Exercise for Operational Risk: Summary of the Data Collected'', Bank for International Settlements, March 2003.

the firm) as well as errors and delays in allocating customer entitlements, such as dividend or interest on securities. **The failure of Essex Capital Management Ltd, an introducing broker, which has cost $6.1 million to CIPF is a case in point**.

- The experience across jurisdictions is that the distribution of losses is heavily skewed: in most cases, losses are relatively small but there are cases in which large losses may arise. The latter will occur, in part, because of the participation of large firms in the investor compensation scheme or, the possibility of a multiplicity of defaults of smaller firms.

4.2 The Structural Characteristics of Mutual Funds

Open-end mutual funds are investment funds generally organized as trusts; only a small percentage of mutual funds in Canada are corporations. The defining characteristic of a mutual fund is that the investor – the unitholder or shareholder – is entitled to redeem its trust units or shares on demand for a proportionate share of the net asset value of the trust or corporation. The units or shares are typically non-transferrable. The investor looks to the fund for liquidity.

In the commercial reality, the fund promoter or fund manager is the driving entity. The manager is typically a financial services firm. The promoter initiates the pooling of capital in the fund and controls the formulation of the funds constitution. The manager controls or manages the funds distribution, administration, or operation. Typically, the promoter or manager will draw together all of the other service providers to the fund or agree to provide some or all of the services itself. The main service providers required are: the custodian, who possesses the investments as bare or custodial trustee; the trustee (in the case of mutual funds organized as trusts) who is the legal owner of the investments such that a trust is created having beneficial ownership interests with the unitholders; the investment adviser, who provides expertise in the investment of the capital; the registrar and transfer agent; and, the distributor[38].

There are four basic types of trustee arrangements (as distinct from the custodian) for mutual fund trusts: (i) the mutual fund manager who also acts as trustee of the funds; (ii) the unrelated registered trust company; (iii) the registered trust company that is related to the manager; and (iv) the individual.

- A mutual fund manager which is also the trustee of its mutual funds is a common arrangement. Implicit in this structure is the proposition that the manager's standard of care under securities legislation to act in the best interests of the mutual fund is not

[38] In this note, the term ''manager'' is used as per OSC Rule 81-107 where it means the ''Investment fund manager'', the person or company that directs the business, operations or affairs of a mutual fund and a ''management company'', the person or company who provides investment advice, alone or together with administration or manager services, under a management contract. R.S.O. 1990, Chapter 5.5

different in kind from the fiduciary obligation owed by the trustee to the unitholders at common or civil law.

- Another prevalent arrangement consists of an unrelated registered trust company acting as trustee of the funds. In this case, the trust company is generally the custodian of the funds as well. These corporate trustees tend to act primarily as custodian and generally delegate most trustee functions to the fund managers.

- The third type of arrangement is a related registered trust company acting as trustee of the funds. In most cases, this kind of arrangement involves a bank – or credit union-owned mutual fund manager coupled with a trust company owned by the financial conglomerate. Again, these corporate trustees tend to also act as custodian of the funds.

- The least common type of trustee used by the mutual fund managers is the individual trustee. Only a handful of the mutual fund managers in Canada have a group of individuals acting as the trustees for their funds. The individual trustees are generally members of the senior management team of the parent company. These individual trustees are generally not independent members and they are active in the governance of the funds.

Mutual funds organizations differ also by their distribution system. One common structure sees a mutual fund manager acting as wholesale distributor of the funds and, in that capacity, assuming responsibility for marketing the funds. While some of these funds may sell directly to the public, the bulk of their funds are sold through broker-dealer networks.

The vertically integrated distribution structure is the other main approach. A good number of mutual fund firms sell their funds to the public through their own exclusive career sales force. Although some conventional mutual fund firms have adopted this organizational structure, it is the rule for bank-owned managers which sell their funds through staff at bank branches and insurance company-owned managers which sell their funds through an exclusive career sales force that is dually licensed as mutual fund sales persons and insurance agents. It is also the case for credit union-owned mutual fund firms which sell to credit union members through the credit union branches. We observe that these firms have a common element: they offer mutual funds to their clients as part of a larger cluster of financial services. Another variant sees firms providing marketing and system support to a dedicated sales force which is deemed to be independent because it is not obligated to sell the firm’s fund.

The mind and management of a mutual trust fund is inverted from what a trust structure usually entails since the manager usually exerts effective control over the fund while here, the trustee is little more than a service provider. This is fertile ground for conflicts of interest arising from both structural aspects and matters of factual circumstances or situations. The fiduciary obligations owed to unitholders by the fund manager and the trustee mainly arise from the constitutive legal regime of the trust itself either at common law or under the Civil Code; the duties are generally quite similar from one to the other legal tradition but are not co-extensive *per se*. Hence, in the case of a mutual fund trust and in light of the large body of jurisprudence on these matters, there is no question ''that a typical fund manager, responsible for decision-making with respect to the day to day affairs and operation of the fund, will be in a fiduciary role vis-à-vis the unitholders of the fund. This is the likely outcome whether one has resort to the standard of care set out in the relevant securities legislation or to the common law principles that have developed for determining the existence of fiduciary obligations[39].'' Indeed, it is correct to assert that the central tenet of Canadian mutual fund regulation is that the fund manager has the responsibility and accountability for managing its mutual funds in accordance with its fiduciary responsibilities.

Although the obligations stemming from private law are broad, they are not considered sufficiently normative to ensure the protection of investors. In all major jurisdictions, regulation of mutual funds under securities law compared to other pooled investment alternatives is extensive. For example and of particular relevance to the risks facing an investor compensation scheme, the mutual fund regulatory framework now requires:

a) The registration of mutual fund managers which are subject to minimum standards designed for the business of managing mutual funds[40]. Registered investment fund managers are required to maintain fidelity bonds or insurance;

b) Any agreement or declaration of trust under which a person acts as manager of a mutual fund must provide that the manager is responsible for any loss that arises out of the failure of it, and of any person retained by it or the mutual fund to discharge any of the manager's responsibilities to the mutual fund. The manager remains responsible to the mutual fund, and therefore indirectly to its security holders, for the duty of care that is imposed by the securities legislation for himself as well as for the service providers which must also perform to the level of that standard of care[41].

c) The establishment of an Independent Review Committee. The mandate of this governance agency which owes its allegiance to unitholders is to resolve conflict of interest situations involving the mutual fund manager, if and when they should arise[42];

d) Restrictions concerning the financial institutions or corporations that may act as custodian[43].

[39] Stevens, David. P – ''Trust Law Implications of Proposed Regulatory Reform of Mutual Fund Governance Structures'', A Background Research Report to Concept Proposal 81-402 of the Canadian Securities Administrators, March 2002.

[40] Quebec Securities Act, R.S.Q.c. V-1.1, section 148, see also sections 159.1 to 159.3.

[41] Regulation 81-102 respecting mutual funds, section 4.4 (C.V-1.1, r.39).

[42] Regulation 81-107 respecting independent review committee for investment funds (c.V-1.1, r.43).

Conflicts of interest are inherent to most mutual fund structures. The investor's ''ownership'' of a mutual fund is separate from the manager's management and control of that mutual fund. Hence, the potential exists for the interests of investors to diverge from the interests of the fund manager. The potential that the self-interest of mutual fund managers will conflict with the interests of investors is further exacerbated by the power imbalance between mutual fund managers and financial consumers. The reality is that the extensive regulations are simply safeguards and means to mitigate the risks inherent to the mutual fund structure; they do not, however, eliminate those risks similarly to traffic laws which do not prevent someone, somewhere, exceeding the speed limit. The risks that confront an investor compensation scheme for mutual fund dealers are shaped by these peculiar organisational and legal arrangements.

4.3 The Design Rationale of the FISF

The impetus that has led to the creation of the FIFS was based on 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.

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 funds distribution component was transferred from the Quebec Securities Commission to a newly created entity, the Bureau des services financiers (''BSF''). Clearly, 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 CIPF which is compulsory for securities firms.

Implementation of this reform 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''

[43] Regulation 81-102 respecting mutual funds, sections 6.2 and 6.3 See generally part 6 *Custodianship and portfolio assets* (C.V-1.1, r.39).

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 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.

In summary, the initial direction of policy was to harmonize the regulations applicable to the distribution of financial products or services by the different segments of the financial sector within the Province. Subsequent developments have seen the harmonization efforts take a pan-Canadian dimension focused on the securities industry and capital markets (including derivatives). In effect, the efforts have shifted from an horizontal approach centered on the distribution of financial products within the Province to a Canada-wide vertical focus centered on securities regulations in a broad sense. 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.

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 the 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 professional 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. The net cost of fraud is often substantial. The data from 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 AMF mandatory insurance requirement does not meet this test.

The point is not that the coverage of professional liability insurance is not important; it is simply that it lacks fraud coverage. It is common practice for financial services firms to

maintain ''errors and omissions'' insurance coverage in addition to fidelity insurance that covers fraud and dishonest acts by employees.

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 fraud committed by an employee or an agent of a firm covered by fidelity insurance. Although financial consumers and a third party with subrogation rights must enter into a settlement with the financial services firm carrying fidelity insurance coverage or secure a judgement in order to obtain compensation, they are nevertheless protected in the case of insolvency of the firm and the recoveries of advances from a compensation scheme are enhanced.

There exists no valid reason not to require mutual fund dealers to maintain fidelity insurance coverage as a condition of registration. NI 31-103 imposes on all 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 would 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. As mentioned above, corporations are able to purchase insurance for certain risks, such as Errors and Omissions, Directors and Officers and other liability insurance, including fidelity insurance that may cover losses resulting from fraud or misappropriation of client assets by employees or their agents. This is the approach that prevails elsewhere, notably in the rest of Canada where the fidelity insurance requirement is embodied in NI 31-103. It is also the rule for all U.S. securities dealers member of SIPC which must maintain blanket fidelity bond coverage which provides against loss without an aggregated limit of coverage[44]. It is revealing that the EC Directive 2004/39/EC on markets in financial instruments provides that if investment advisers purchase appropriate indemnity insurance cover, they may be excluded from some regulatory capital requirements that would otherwise apply to the firms. Thus, insurance is also seen in the European Union as an effective alternative protection mechanism to firm capital.

4.4 The performance of FISF compared to other investor compensation schemes

The financial costs incurred by the four North American investor compensation schemes under review to cover the shortfall in assets resulting from the insolvency or the fraudulent actions of

[44] Financial Industry Regulatory Authority, FINRA Rules, ''4360. Fidelity Bonds''.

securities or mutual funds dealers provide useful insights for the assessment of the performance of the FISF.

- 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 1.35% of this total net cost[45].

- IPC began offering coverage on July 1, 2005. Since that time, it has dealt with the insolvencies of three mutual fund dealers[46]. 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.

- Since 1999, FISF paid a net amount of $45.8 million in compensation to 1,399 eligible claimants[47]. 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 it would be fair to add the $20 million paid by the AMF in the settlement of the class action undertaken by some Norbourg investors.

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[45] 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.

[46] 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.

[47] 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)

4.4.1 Comments and Observations

- 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 since its inception in 1999 ($37.8 million plus $20 million) 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.

- 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 1969.

- Capital adequacy of financial services firms is the most important safeguard to prevent the dissipation of customer assets. In the United States, the Lehman Brothers Inc. bankruptcy, the largest SIPC liquidation in history, was rooted in the precariousness of this highly leveraged firm[48]. It is significant that following the adoption of the Financial Responsibility Rules in 2009, no new insolvency cases where trusted in SIPC's care in 2009 and 2010[49]. In Canada, the last securities firm insolvency case involving CIPF dates to 2002.

[48] As at December 31st, 2010, the trustee had determined claims in the amount of $180 billion. It has been reported that financial consumers and investors have emerged unscathed from this bankruptcy, the main cause for the failure being related to counterparty positions in financial derivatives transactions.

[49] The failure of MF Global in November 2011 put a dent in this winning streak. It serves as a stark reminder of the risks related to propriety trading in futures and financial derivatives.

With respect to mutual fund dealers, a strong emphasis must be placed on financial compliance, to ensure that the rules for the segregation of customer assets are duly respected and that the accounts of the mutual fund manager balance with those of the depositary and, sales compliance, particularly in regard to unapproved business activity and abusive sales practices. Experience in Europe and North America shows that fraud and irregularities with respect to mutual funds generally occur at the manager and dealer levels, not at the custodian or registrant level.

- Contrary to the other Canadian investor compensation schemes, FISF is not recognized as a *customer compensation body* under the *Bankruptcy and Insolvency Act*.

V. Measures to enhance the protection of Quebec Mutual Fund Investors

Financial enterprises which know long-term success are anchored in the belief that they must continuously meet the highest standards of integrity and performance, informed by a genuine concern for the well-being of the individual investors and clients which trust their savings to them. They harbour a profound abhorrence for firms or individuals that engage in abusive practices, trick individual investors in unsuitable investments or shams or, worse, who embezzle or defraud them.

Financial consumers are exposed to a range of risks when engaging a financial services firm to carry out investment services on their behalf. A comprehensive apparatus and mechanisms have been put in place to provide protection against the various risk exposures of financial consumers. These either are prescribed by regulation (eg, prudential regulation, segregation requirements, other conduct of business rules, supervision and enforcement), or emerge from institutional arrangements (eg, economic capital of investment firms, firm reputation, private insurance cover). The arching proposition is that it is much preferable to prevent harm to financial consumers than to compensate injuries after the damage has been done. Hence, our recommendations are grounded in this simple, yet fundamental, truth.

The better the protection provided by the alternative protection mechanisms, the lesser the need and resource requirements for a statutory investor compensation scheme. However, past experience suggests that there have been instances where the alternative mechanisms have failed and investors would have incurred significant losses, had it not been for the existence of a compensation scheme. The investor compensation schemes established in all jurisdictions with developed capital markets therefore play an important complementary role in providing last resort protection for financial consumers.

In all major jurisdictions, investor compensation schemes provide important protection against the risk that, in the event of default, a financial services firm is not able to return to investors the cash or investment instruments belonging to them. In such circumstances, the schemes therefore protect investors' assets against the risk of theft, embezzlement and other forms of fraudulent misappropriation. They also provide protection where the loss of consumer assets in the event of a firm insolvency resulting from unintentional errors, negligence or breakdowns in the firm' systems and controls. The FISF is, in our opinion, wanting on these dimensions.

We subscribe to the need for a demanding regulatory regime that addresses both the prudential and business conduct dimensions. To be effective, such a regime must:

- Place significantly more weight on ex-ante measures than ex-post corrections. The priority must be to prevent financial consumers from being harmed in the first place, not to be content in punishing wrongdoings after the malevolent deeds have been visited upon them.

- Reflect the characteristics and dynamics of the new retail investors environment and of the industry.

- Take full account of the regulatory regimes and approaches prevalent in other jurisdictions, their experiences and the lessons they have drawn over the years.

Our recommendations partake from these three fundamental points.

5.1 The active promotion of best practices within the financial industry

The focus of the AMF with respect to the protection of financial consumers, particularly senior investors, should be the promotion of best practices in matters of compliance, supervisory and other practices used by financial services firms in serving these consumers[50].

To this effect, a proactive initiative by the AMF could take the form of an annual forum where a cross-section of securities professionals, financial services firms and researchers specialized in the area from Quebec and other jurisdictions would be invited to share their practices in serving financial consumers.

For example, a forum focused on elder financial consumers would address the following important operational and compliance matters:

- How firms are structuring their supervisory and compliance structures to meet the peculiar needs of senior investors.

- Training and educating firm employees on senior-specific issues (i.e. identification of signs of diminished capacity and elder financial abuse by relatives or other confidants).

[50] The Report on Protection of Vulnerable Persons published in October 2011 is a useful contribution by the AMF to the broad efforts required to improve the protection of vulnerable members of society who need assistance in managing their assets

- Communications with senior investors.
- Advertising and marketing to senior investors.
- Internal processes for escalating individual investor-related issues.
- Ensuring the appropriateness of investments.
- Establishing age-based restrictions on certain products or product features.
- Senior-focused supervision, surveillance and compliance reviews.

The lessons learned and the conclusions of these forums, augmented by additional information gathered from individual firms and from the work of other regulatory agencies and research institutes focused on such issues could be summarized in a report aimed at providing information on best practices, a description of specific and concrete steps adopted by firms, and guidance regarding the servicing of financial consumers, particularly senior investors.

In this regard, we commend the AMF for having taken the leadership in controlling the use of senior-specific titles and professional designations in Quebec. The findings of the taskforce of the North American Administration Association (''NASAA'') and the comments in IIROC Annual Consolidated Compliance Report for 2011 highlight the issues associated with the aggressive and unsupervised use of ''senior designations'' which are intended to convey an impression of specialized proficiencies and credentials and lead financial consumers to believe that the representative is better qualified to provide investment advice. Their recommendation that specific rules be adopted to prevent such abuse is already implemented, with good effect, by the AMF.

5.2 Harnessing the full power of the flows of Information

Private and public regulatory bodies are at a distinct disadvantage in gaining access to the formal and informal flow of information, particularly in deciphering the tidbits of informal information that circulates in an industry. The necessity to operate at arm's-length and the fragmentation of the industry are major structural factors which explains this state of affairs.

Whistleblower programs have been adopted by many North American jurisdictions to bridge the gap. Generally, a whistleblower is an individual who, alone or jointly with others, voluntarily provides the regulatory authority information that relates to a possible violation of securities laws including any rules or regulations thereunder that has occurred, is ongoing, or is about to occur. In the United States, a whistleblower may remain anonymous when reporting possible violations to the SEC, but, to do so, must report through an attorney.

The Dodd-Frank Act contains provisions aimed at augmenting the efficacy of the whistleblower program in assisting in the timely enforcement of securities regulations. In accordance with the

Act, the SEC adopted, on May 25, 2011, Whistleblower Rules which establish the standards and procedures the SEC will apply in awarding whistleblowers monetary compensation for providing tips about possible securities law violation that lead to successful SEC enforcement actions and set the contours for protections of whistleblowers under the Act's anti-retaliation provisions. Eligibility for an award under the Whistleblower Rules can be summarized as follows: Ii) a whistleblower, (ii) who voluntarily provides the SEC, (iii) with original information, (iv) that leads to a successful enforcement by the SEC that results in monetary sanctions of more than $1 million arising out of the same core facts, (v) is eligible for an award of 10 to 30 percent of any amounts recovered, up to a maximum of $2 million.

In Canada, CIPF has adopted whistleblower policy to encourage the reporting of questionable accounting or auditing matters concerning securities firms. IIROC also has a Whistleblower Service that ''…has been established to receive, evaluate and take prompt and effective action on reported first-hand knowledge or tangible evidence of potential systemic wrongdoing, potential securities frauds or unethical behaviour by IIROC-regulated individuals or firms[51].'' The first point of contact for all users of the Whistleblower Service is either a Manager or a Director of Case Assessment who provide an initial assessment and then whistleblowers may deal directly with a member of the IIROC Whistleblower Team which consists of three senior staff members.

Whistleblower programs have proven to be a powerful means to harness the contribution of a wide span of individuals that interface with financial services organizations, registered or illicit, and thus obtain valuable information the regulators may not otherwise obtain. It is undisputable that industry professionals and cautious investors are most likely to become aware of unusual patterns of activity and to encounter first the most common ''red flags'' indicative of potential fraudulent activities: claims of returns that are consistently high even in down markets, non-disclosure of affiliates or misrepresentation of custodial arrangements.

The AMF manages reports of any suspicious activity brought to its attention, in addition to its complaint assistance program. A provision recently adopted modifying the *Act respecting the Autorité des marchés financiers* that guarantees immunity from civil liability to whistleblowers who report suspicious activity in good faith constitutes an element critical to the success of such programs[52].

In Ontario, the OSC Investor Advisory Panel recommends in its 2011 Annual Report ''a whistleblower regime which provides certain protections and/or compensation to individuals who report securities law violations to the Commission.'' The Chair of the OSC has indicated that the Commission has undertaken the study of such a whistleblower program.

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[51] IIROC, ''IIROC announces creation of Whistleblower Service'', May 25th, 2009

[52] Section 17.1 as added by *An Act to amend various legislative provisions mainly concerning the financial sector*, S.Q. 2011, c. 26, section 4.

The critical issue confronting Canadian securities regulators is whether a whistleblower program should be designed as a bounty program. The need to assess the current framework in light of developments in the United States under the *Dodd-Frank Act* is obvious. The comments by the Chair of SEC that the result following the introduction of the new rules concerning the Whistleblower Program and the ease of access through their website ''is that the quality of the tips we receive has improved substantially and generated a number of cases now in the pipeline'' cannot be overlooked[53]. In the European Union, this approach is also under consideration in the ongoing review of MiFID.

We are acutely aware of the ethical issues associated with the State relying on paid informants to ensure abidance by the law. Bounty programs also raise practical issues such as the risks that they undermine the integrity and effectiveness of issuers and registered financial services firms internal reporting and compliance systems. Hence, we will urge caution and suggest that a gradual approach in implementing such a program is warranted. One early candidate the AMF may consider is the establishment of a bounty program in cases where the information leads to the identification of individuals or organizations that promote or engage in financial investment activities with financial consumers without the proper registration. We think, here, of cases such as the Earl Jones scam where the harm to investors is considerable, the more so since their losses were not covered by FISF.

In conjunction with such a measure, the AMF should consider recommending legislative changes to significantly increase the financial penalties for individuals or firms ''selling'' financial products of dubious value to retail investors without any registration and the opportunity to introduce the ''Fair Fund'' mechanism to compensate financial consumers injured by such scams.

5.3 Empirically based regulations

The Education and Good Governance Fund (''EGGF'') is a major AMF initiative that improves our knowledge of key aspects of the financial sector and its many facetted intercourse with the economy and investors. We suggest that much would be gained by committing funding to the sociological study of white collar financial fraud, both with regard to the characteristics, motivations and behaviour of professionals who engage in or condone fraudulent activities and to financial consumers which are more vulnerable or more likely to fall prey to financial scams.

A successful program and accompanying regulations to reduce the incidence of fraud in the distribution of financial products is more likely to yield significant results if they are based on a rigorous body of empirical evidence. For instance, findings concerning ''elder fraud'' go against the conventional wisdom. Older people are targeted simply because they often have more

[53] Mary Shapiro, ''Comments'', Stanford Center for Longetivity – FINRA Investor Education Foundation Conference, Washington, D.C., November 2011

money – not necessarily because they are frail and helpless. Far from being less financially savvy, they are often more so, having trusted relationships with financial advisers and institutions. They are not less financially literate. In fact, victims typically include doctors, lawyers and business executives. This does not suggest that programs aimed at raising awareness about the dangers of financial abuse among the elderly such as the joint AMF – Association québécoise pour la défense des personnes retraitées et préretraitées are not important. On the contrary. However, they do not provide a guide to policy formulation.

Successful consumer manufacturers and services companies draw on a substantial body of academic studies and survey and tests results to ensure their products fulfill consumer expectations and their communications are on target. The same rigorous discipline should inform the policies and actions of regulators with respect to the protection of financial consumers against fraudulent or unwarranted behaviour.

The AMF has the opportunity to draw on competent academics in Quebec universities in the fields of criminology, sociology and psychology to address the problems from an angle and with tools which, heretofore, have generally not been used to assist in the design of prevention policies and regulations. The AMF should make this one of the major area of research for EGGF.

5.4 The case for fidelity insurance coverage requirement

Securities dealers, securities advisers and fund managers are required to maintain fidelity insurance coverage against losses incurred by the firm (i.e. the financial consumers) as a result of fraud and unlawful actions on the part of an employee. This insurance coverage is mandated by NI 31-103, a national policy to which AMF otherwise subscribes.

We submit that the exception to this insurance coverage requirement for mutual fund dealers 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 FIFS and compliant members of the mutual funds industry. The limitations of the present approach are highlighted through the examination of the various mechanisms that may be instituted to facilitate the fair and timely settlement of financial consumer claims.

It has been suggested that the virtue of the present Quebec approach is that in cases where the eligibility requirements are met, the claimant is entitled to an indemnity from FIFS, regardless of the financial situation of the firm at fault. Following payment of the compensation, FIFS will attempt to recoup its costs through the exercise of subrogatory rights against all the registered entities at fault.

On the contrary, we find this approach to be fundamentally mistaken for the following two reasons. First, the approach undermines the basic tenet that corporations must be held responsible for the errors, omissions, malpractice and fraudulent actions committed by their employees in the course of business. Second, if the mutual fund dealers carried fidelity insurance with respect to fraud committed by their employees, FIFS would not, in such circumstances, be required to make compensation payments and, if it needed to do so because of the failure of the firm, it would be assured to recoup its ''advances'', notwithstanding the failure of the firm at fault.

Some may argue that fidelity insurance coverage may not be economically available for small mutual fund dealers. MFDA counts 53 members (out of 132) which employ 10 Approved Persons or less. These firms are covered by fidelity insurance. Why would such coverage be out of reach for Quebec-based mutual fund dealers? Similarly, fidelity insurance coverage is mandatory for registered securities broker-dealers. This requirement has not prevented the emergence of ''introducing brokers'' which, as a rule, are small firms. In its December 2010 submission to the AMF with respect to proposals to harmonize the regulation of the mutual funds industry with the regime that prevails in the rest of Canada, the Chambre de la sécurité financière opposed the AMF proposals on the grounds that it would benefit the larger mutual fund dealers and that financial consumers would be penalized by a regime that discriminated against a certain category of dealers[54]. We concur with the view that discriminatory policy is not sound policy. However, this axiom is not unidirectional. A policy that discriminates against financially sound firms by preventing them from acquiring and implementing a much more effective investor protection instrument because weaker firms may not have access to it is not a policy stance that can be countenanced. The benefits to all, financial consumers, firms, AMF and government, are to important to be simply discarded for specious reasons.

Moreover, if considered important from a public policy point of view to encourage the entry of small dealers in the market with thin capital requirements and, in the absence of a private insurance market, solutions exist to correct the situation. For example, the AMF could establish an umbrella fidelity insurance plan for firms unable to insure their operations in the insurance market. The firms availing themselves of this plan would pay premiums commensurate with AMF's assessment of the risks they present, an exercise which may be valuable for many other aspects of the surveillance of mutual fund dealers. Since the AMF ultimately controls the risks associated with those firms through its surveillance and enforcement activities, it is in a privileged position to assess them correctly. Consequently, all mutual fund firms would be on a

[54] ''Après nous être interrogés sur le poids à donner aux conclusions d'une analyse qui laissent entendre que les neufs courtiers québécois membres de la MFDA méritent d'être avantagés par l'exercice d'un pouvoir de réglementation au détriment de leurs 34 autres concurrents basés au Québec – on sait d'ores et déjà que ces derniers écoperont lourdement au terme de cet exercice – la Chambre a conclu qu'une approche qui a pour effet de discriminer une minorité en faveur d'une majorité est rarement bonne conseillère. Une telle approche ne peut que créer des inégalités de traitement et des distorsions concurrentielles dont les consommateurs feront les frais.'' Mémoire de la Chambre de la sécurité financière en réponse à la consultation relative à l'harmonisation de la réglementation du secteur de l'épargne collective, 6 décembre 2010, page 19.'

level playing field where the premiums they pay to their insurer or the AMF sponsored plan would reflect their management, governance and financial performance.

5.5 Promoting alternative settlement mechanisms

All registered firms that offer financial products or services must establish an internal mechanism for examining complaints from financial consumers which believed they have been wronged by the firm or a representative in its employ. This requirement first introduced in December 2001 in the law creating the AMF is now standard procedure across the country. For instance, recent Federal legislation and regulations make it mandatory for banks to be a member of an *external complaints body* approved by the Commissioner of the Financial Consumer Agency of Canada and establish requirements for their internal complaint handling process.

A consumer not satisfied with the resolution offered by a mutual fund dealer in Quebec has two avenues opened to it. If the financial services firm is a member of MFDA, it may submit its complaint to OBSI. The financial consumer has also the right to require the AMF registered firm to send a copy of the file to the AMF, which will assess the complaint and if necessary, offer mediation services between the parties. The conciliation and mediation services offered free of charge to financial consumers are dispute resolution mechanisms available to them on a voluntary basis. The AMF and OBSI do not pay any monetary compensation with regard to consumer claims except, in the case of AMF, for claims specifically covered under its compensation programs. The OBSI reports that the sum of the monetary settlements in 2011 for claims pertaining to investment services (of which 417 out of 468 cases concerned mutual funds and securities) amounted to $3.3 million with an average of $19,121 per case. With respect to the AMF, it reports that in fiscal 2010-2011, 746 complaints benefitted from its conciliation and mediation services; a settlement was achieved in 68% of those cases[55]. Although the firms are expected to abide by the recommendations and pay the settlement amount, they are not binding on either the consumer or the firm.

The efficacy of the claim resolution mechanism could be improved through the imposition of a binding arbitrage process on the parties. Such an approach would provide financial consumers with an alternative to the civil court system through access to an adjudication process which combines all the regulatory and financial loss matters in a single proceeding. It would ensure that payment for fraudulent actions by employees or agents of a firm covered by fidelity insurance will be paid since the cost to the firm would be determined by an independent body. Hence, the advantages for financial consumers of the current AMF approach would be preserved without taxing the investor protection scheme and, by way of consequence, the Quebec mutual funds industry. In many respects, a binding arbitration process would be akin to

[55] The AMF does not publish data on its recommendations for monetary compensation and for cases where it facilitated monetary settlement.

the regime in Manitoba, New Brunswick and Saskatchewan, where the Securities Commissions have the power to order repayment to an investor for losses arising from illegal or improper conduct relating to the trading of securities.

It must be noted that members of IIROC are required to submit to binding arbitration should a client asks for this resolution mechanism and the claim is for $500,000 or less. In Quebec, the procedure is conducted under the aegis of the Centre Canadien d'Arbitrage Commercial. We are aware that recourse to arbitrage has been sparse in recent years. However, we are also cognizant of ongoing efforts by the Ministère de la Justice du Québec to modernize the legal framework and the interest of several parties to streamline access. Here again, we suggest that it is in the interest of financial consumers and the AMF to close the gap between the investor protection regime applicable to Quebec investors that acquire units or shares of mutual funds through a securities dealer as opposed to a mutual fund dealer.

We recognize that a mandatory binding arbitration regime would curtail the rights of either party to seek civil remedies before the Courts[56]. Moreover, in some cases, the moneys in play may be too important to eliminate rights of appeal to a higher authority. These issues could be resolved by establishing that the decision of the arbitrator (or panel of arbitration) is binding on both parties up to a specified amount. We would suggest $150,000 as a reasonable threshold.

Some may argue that the proposed threshold may cause certain firms to seek bankruptcy protection in the event a ruling went against it. Firstly, this objection does not generally hold if the firm is covered byfidelity insurance. Secondly, it implies that the capital adequacy requirements are insufficient to cover the risks inherent in the Quebec mutual fund dealers sector. Experience has demonstrated that thin capitalization rules to encourage competition and stability within any segment of the financial sector is a flawed policy. Moreover, this objection states the obvious: the regulations should require fidelity insurance coverage which would cover *bona fide* cases of fraud by employees or agents rather than professional liability which does not cover such delinquent acts.

5.6 Establishment of an insolvency scheme for mutual fund dealers

In all jurisdictions we have examined, investor compensation schemes for the securities and mutual fund industries only pay compensation in the event of default of a firm, for whatever cause. No scheme provides payment prior to the point where a firm is declared to be insolvent

[56] In some jurisdictions, notably the United Kingdom, the recommendation of the Ombudsman is binding on the firm, if accepted by the financial consumer. The latter may reject the proposed settlement and go to court. In the United States, members of FINRA (i.e. securities dealers) are required to submit to arbitration if requested by a customer. The ruling is binding on the firm, not on the customer. Several firms required in their customer account agreement that the customer accept to be bound by the arbitration ruling and forfeit their right to go to court. The U.S. Supreme Court has ruled that such contractual agreements were valid.

due to its inability to return client assets. **By design, all the schemes in the European Union and North America, except Quebec, are insolvency schemes.**

The argument against investor compensation schemes covering situations prior to default is that the financial consumer has other avenues of redress at this point, and that there are presumably assets to satisfy successful claims. Admittedly, there may be situations where a financial consumer has suffered a loss (i.e., from operational failures), but where they are unable to hold the firm or another party liable for the loss. This is not to say that investor compensation schemes should step in and compensate prior to a firm default. However, it does suggest a need for regulatory mechanism alternatives that provide financial consumers or regulators with a means of redress prior to a firm default such as an independent complaint adjudication mechanism and ''Errors and Omissions'', ''Directors and Officers'' and fidelity insurance coverage. Such redress mechanisms are common features of the investor protection architecture in other jurisdictions.

The change in purpose of the investor compensation scheme for mutual fund dealers into an insolvency protection scheme is critical for the effective protection of financial consumers.

Notwithstanding the limits to coverage written in the policies of insurance compensation schemes, it is now established that in cases of failure of a financial services firm comprised of member and non-member affiliates, the customers of the non-member affiliate are generally entitled to compensation. The rules established by the Courts in cases involving non-member affiliates can be summarized as follows:

- Customer status does not depend simply upon to whom the claimants write a check to purchase securities;

- To the extent the member firm acquired control of the customer funds deposited with the non-member affiliate and that the claimants purchased financial products that qualify as securities or eligible investments under the law or the scheme, the financial consumers are covered.

The design of the investor compensation scheme for financial consumers should reflect this state of affairs.

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[57]. 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

[57] It is noteworthy that in the case of Norbourg where the activities were limited to Quebec, fifteen mutual funds were common law trust established and governed by Ontario laws and twelve were trusts established and governed by the Quebec Civil Code.

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 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?

The review of policies concerning investor protection schemes in the European Union and across North America and of the organizational structure of such schemes in North America leads to the following conclusions. Quebec customers of mutual fund dealers should be covered by an insolvency protection scheme which should be:

- A nongovernmental stand-alone organization, 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;

- The organization must be 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 nor would it be for the Coalition AFIF proposal;

- This organization must be 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 should be given to reach the fund's target level.

Two options are open to the AMF to implement this recommendation. The first would entail the recognition of the MFDA as an SRO and the expansion of its coverage to Quebec financial consumers. Since CIPF is recognized by the AMF and provides coverage for all registered securities firms active in Quebec, the necessary interfaces between the AMF and such a national compensation scheme are thus already well known and would be easy to duplicate with IPC.

The second option would consist in the establishment of a Quebec compensation fund for the mutual fund industry. This option is clearly a ''second best'' solution because it would mean duplicating IPC, a Canadian scheme that is already very well established and capitalized, and it would needlessly impose a high financial burden on the Quebec mutual funds industry since the level of funding of the fund commensurate with the risks insured would necessarily translate in higher assessments than would otherwise be the case. In any case, the levies will have to be sufficient to fund the compensation payments. Moreover, this option does not resolve the intricate issues related to the interactions with the workings of the *Bankruptcy and Insolvency Act*, particularly in the case of the bankruptcy of a national mutual fund dealer domiciled in another province active in Quebec.

5.7 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 dysfunctional consequences. In particular, it:

- deprives the industry and the AMF from the benefits stemming from the extensive industry 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 ''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 limit its 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 by IPC nor 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. In this regard, the provisions embodied in the AMF Decision of 2004 recognizing the Investment Dealers Association as an SRO contain all the safeguards the AMF may require to ensure that its legislative mandate is fulfilled, services are provided in French and English and that due consideration will be given to the characteristics and needs of the Quebec mutual fund industry[58]. For Quebec mutual fund investors, recognition of MFDA as a SRO 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.

5.8 Preparing for the failure of a large financial services firm

Looking forward, there is no room for complacency because changes in capital markets and the financial industry are making the regulators' job of monitoring net capital adequacy rules and protecting investors more difficult. The structure of financial services conglomerates and of holding companies are becoming complicated and enmeshed in a complex web of jurisdictions with different, if not competing, interests or legal requirements. This is particularly acute in the case of bankruptcy of a financial services firm or liquidation of mutual funds. Although custodians and sub-custodians are required to take such additional steps considered necessary to protect the portfolio assets of the mutual fund in a foreign jurisdiction and to ensure that those portfolio assets are unavailable to satisfy the claims of creditors of the custodian or sub-custodian under the laws pertaining to creditor protection and bankruptcy of any foreign jurisdiction in which portfolio assets of a mutual fund may be located, it is not iron-clad certainty that this will effectively be the case in all circumstances or that a satisfactory final resolution may be achieved only through protracted legal proceedings. These complexities will impede the timely resolution of Quebec customer claims.

Experience has demonstrated that the ability to satisfy customer claims in a timely fashion is directly related to the actions taken within the first hectic days of a liquidation's commencement. Within that short time period, the trustee in bankruptcy must: i) gain control of the headquarters and branches of the financial services firm in liquidation; ii) freeze all customers accounts and creditor claims; iii) identify the location and availability of the customers securities and cash; iv) determine the feasibility of a bulk transfer of customers accounts to one or several firms in good standing.

The range of issues that would confront the AMF in the case of a large mutual fund dealer or mutual fund firm is staggering. Their complexities increase by at least one order of magnitude if such a bankrupt firm was headquartered in another province, or abroad. The potential negative impact on financial consumers is too large to let the management of the crisis it would likely engender to happenstance. The argument that such a scenario is unlikely does not justify the failure to plan the management of disruptive events nor is the acceptance that facts and

[58] AMF, Decision N° 2004-PDG-0083

circumstances are varied a valid excuse. It is utopia to believe that all the ‘’black swans’’ have migrated elsewhere.

We recommend that the AMF establish a task force (with adequate resources) to study ways to ensure the timely return of customer property in the event a large mutual fund firm was to fail, either because of fraudulent actions or mismanagement and to develop a plan for large liquidations. This task force should include legal experts familiar with the operations of bankruptcy laws applicable to banks, insurance companies under the jurisdiction of the Federal Government and securities firms and experts familiar with the information and management systems of large financial firms. It could, as a first case, conduct a post-mortem of the management of the bankruptcy of FM Global Canada by the SROs concerned and of the cross-border issues that have or could have occurred.

In all jurisdictions, bankruptcy and insolvency laws closely interact with the workings of investor compensation scheme. This is certainly the case in Canada with the added complexity that bankruptcy law is under federal jurisdiction whereas securities regulations, including mutual funds and investor compensation schemes, are governed by the provinces. The work of the task force would yield the additional benefit of identifying the amendments, if any, that should be brought to the *Bankruptcy and Insolvency Act* to enhance investor protection across Canada and in cross-border situations.

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