BY JAMES HYMAS

IIROC's slush fund

Is the money going where it should?


HYMAS

IIROC currently holds over $32 million in an Externally Restricted ABCP Fund derived from fines and interest — a substantial sum of money by anybody's standards.

With IIROC expected to settle the disposition of the fund later this year, investors, advisors and legislators should consider the issues surrounding this fund and determine whether legislative and procedural changes are needed.

The fund is the result of fines levied against Scotia Capital ($29 million), Credential Securities ($200,000), and Canaccord Financial ($3.1 million) for their roles in the August 2007 collapse of the Canadian non-bank asset-backed commercial paper (ABCP) market.

The grounds upon which fines are levied are open to question, but the main issue is IIROC's conflicting roles of judge, jury, prosecutor, investigator and, critically, determiner of the disposition of the proceeds of fines.

Legitimacy of the fines

IIROC has claimed it investigated "more than 100 investor complaints." Oddly, not a single one is specified in any of the three settlement agreements, nor is any kind of connection drawn between the substance of these complaints and the agreements.

The prospects of receiving a large cheque — rather than revoking a licence or two — may influence IIROC's conduct in the course of pursuing settlements.

The media has reported some of the affected investors were told their investments were "just as safe as GICs." This is a clear misrepresentation worthy of penalization by the regulators, but not a single advisor has been penalized by the regulators for such an assertion.

However, IIROC did produce an extraordinarily verbose report on the ABCP market and its collapse. The report emphasizes suitability as the standard for selling investment products to retail clients, but doesn't consider the question of concentration. In fact, the words "concentration" and "diversification" are each found only once in IIROC's regulatory study, and in both cases with reference to ABCP itself, not the portfolios of the investors.

The importance of portfolio diversification is well known to investment practitioners and academics, but IIROC has an explicit goal of revising its compliance modules to focus on suitability issues.

It seems clear "suitability" needs to be replaced with some version of the Prudent Investor Rule. While ABCP and many other things may be suitable for a retail investor's account, a heavy concentration of anything is imprudent.

IIROC proudly states it may add "the account's current investment portfolio composition, duration and risk level" as a suitability factor to the Client Relationship Model (CRM) proposals, but it remains to be seen how this requirement will be monitored and enforced if enacted.

Whatever the faults of ABCP, its credit quality was well within normal bounds. The three "Master Asset Vehicles" set up to receive the majority of the assets of the ABCP conduits have current credit ratings varying from BBB(low)(sf) to A(high)(sf).

The collapse of the Canadian non-bank ABCP market was not so much a failure of credit quality as it was a failure of market liquidity. The Bank of Canada has since taken steps to improve the liquidity of the market in future crises as part of its market development efforts.

The IIROC report stresses dealer members are required to understand the underlying asset composition of instruments sold to clients. But no one has taken action against those who failed to investigate related financial instruments sold or recommended to clients, such as the National Bank Money Market Fund, which held 49.42% ABCP on March 31, 2007.

These peculiarities pale in comparison to the fine IIROC levied on Scotia Capital. The ruling cites that one part of the firm did not talk to another, contrary to what is now Dealer Member Rule 29.1(ii).

This rule is a ridiculous catch-all provision that states "Dealer Members […] shall not engage in any business conduct or practice unbecoming or detrimental to the public interest."

A fine of this magnitude for such an offence, which did not involve anybody outside the company, should be considered an affront to the most rudimentary notion of justice.

IIROC claims there are other, clearer contraventions, but evidence to support their position cannot be found in the settlement agreement, where one would expect to see references to specific Dealer Member Rules.

The claim that Scotia Capital "continued to sell Coventree ABCP without engaging […] other appropriate processes for the assessment of such emerging issues" is unclear and fails to serve the public interest.

To make matters worse, the settlement agreement specifically notes Scotia Capital is "increasing the number of compliance positions supporting the Respondent's wholesale business," and requires a consultant report to IIROC regarding Scotia's fulfillment of this action.

In short, I question whether IIROC has served the public interest in this matter. Nevertheless, the fines, which with interest total over $32 million, are now sitting in IIROC's coffers, awaiting disposition as determined by IIROC's directors.

Problems with "proceeds of crime" laws

The ability of IIROC's board to determine the disposition of revenue derived from fines is directly analogous to current Proceeds of Crime legislation, under which assets can be seized by the state in a civil action and the proceeds disbursed for purposes of victim compensation, cost recovery and grants.

According to the Ministry of the Attorney General, "Organizations eligible for grants are designated by the act, including law enforcement agencies and Ontario government ministries, boards and commissions. These institutions must meet the established criteria and submit a project proposal outlining how the grant will assist victims of unlawful activities or prevent victimization."

As of August 2007, only a quarter of the funds seized continued on page 26

FAIR/OSC CONNECTIONS

ERMANNO PASCUTTO was executive director of the Ontario Securities Commission (OSC) from 1984 to 1989.

STANLEY BECK, FAIR chairman, was the chair of the OSC from 1984 to 1989.

NEIL DE GELDER, also on the board, was executive director of the British Columbia Securities Commission from 1987 to 1990.

ED WAITZER, who was chair of the OSC from 1993 to 1996, was a member of the founding board of FAIR.

ILANA SINGER, deputy director, was more recently with the OSC as senior advisor, International Affairs.

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under this legislation had gone to victims. But there are further problems beyond the disposition, which are best exemplified by the continuing debate regarding asset forfeiture in the United States. One guide for law enforcement officials states the primary argument for supporting "the need for forfeiture" as follows: "For many years, law enforcement agencies around the nation have faced shrinking budgets. […] asset forfeiture can assist in the budgeting realm."

David Harris of the University of Pittsburgh points out, "Police have an incentive to gear law enforcement toward crimes that will result in forfeitures […] The prospect of a big payoff has a corrupting influence on police priorities […] to the detriment of targeting less lucrative but more damaging street-level crimes."

It is, of course, impossible to say for certain whether IIROC's enforcement process has been influenced by the prospect of levying large cash fines against corporations.

But it's puzzling that after having received "more than 100 investor complaints" they:

- Did not name a single complainant
- Did not detail a single complaint
- Did not name an individual whose conduct could be criticized
- Did not revoke a single licence
- Did not identify specific conduct by Scotia Capital that harmed the public
- Reached an extremely vague settlement agreement behind closed doors.

The prospects of receiving a large cheque — rather than revoking a licence or two — may influence IIROC's conduct in the course of pursuing settlements. But what does IIROC do with the fines it collects?

How IIROC disposes of fines

IIROC's 2010 annual report lists two external initiatives funded by its "Externally Restricted Fund": $282,000 to the Canadian Foundation for the Advancement of Investor Rights (FAIR), with a remaining commitment of $1.6 million; and $201,000 to the "Funny Money project," with a remaining commitment of $357,000.

After these expenditures, along with $1.8 million in hearing panel-related costs and $224,000 on a Rule Book revision (paid to or disbursed by IIROC staff), the balance in this fund was $27.4 million.

The Funny Money project seeks to address financial literacy issues among high-school students, focusing on "the day-to-day realities of paying the rent, properly using a credit card, budgeting for the basic necessities or investing for their futures." The program's other sponsor is the Investor Education Fund (IEF), which is funded by settlements and fines from OSC enforcement proceedings.

The IEF states, "To be considered, these initiatives must contribute measurably to the development of consumers' financial and investment know-how. The expected results from each project must be clear and measurable."

When questioned, the IEF provided me with some impressive figures regarding improvements in self-assessed student financial literacy as a result of Funny Money presentations. For example, after the presentation, almost 80% understood the concept of compound growth, compared to just over 30% before.

It is with respect to FAIR that an investigation of IIROC's granting practices are most interesting. The founder and current executive director of FAIR is Ermanno Pascutto, who requested funding from one of IIROC's predecessor organizations, Market Regulation Services, at a time when he served on its board as an independent director. The Investment Dealers Association (IDA) was also solicited for funds. Pascutto was able to secure a commitment for three years of funding to a maximum of $3.75 million.

Issues of groupthink

The sidebar on page 25, "FAIR/OSC connections," shows many prior career parallels among FAIR's principal actors. It is not particularly difficult to find similar career overlaps and parallels between these players and the boards of the two granting agencies, which merged to become IIROC in 2008.

FAIR's heavy concentration of ex-regulators could be justified if FAIR was taking meaningful action to gain credibility as a voice for the investors whose interests it claims to advance.

To its credit, FAIR has added the founder of the Small Investor Protection Association (SIPA) to its board. But FAIR has no social media presence, no membership and no formal mechanism through which it seeks to obtain the views of actual investors prior to pronouncing its position.

Why have regulators allocated $3.75 million to form an organization controlled continued on page 28 continued from page 26

by ex-regulators? This is a recipe for groupthink. Such a problem is further exacerbated by the fact that IIROC judges FAIR's success by its impact on the regulatory process, the measurement of which includes the regulatory response to FAIR input and FAIR's inclusion in regulatory initiatives.

It is hard to imagine a more circular feedback mechanism than one where IIROC can burnish the perceived success of its funding of FAIR by including FAIR in IIROC deliberations.

The UK's Warwick Commission has warned against over-reliance on like-minded individuals, however expert and apolitical, and emphasized regulatory capture can be as much a matter of intellect as self-interest.

The IMF blames groupthink for its shoddy performance in the prelude to the financial crisis. If IIROC wishes to improve regulation in Canada, it should fund an organization more likely to criticize it than to seek inclusion in its processes.

Instead, IIROC's support of an extraordinarily well-funded advocacy group may be viewed as an attempt to capture the public debate. Smaller groups, operating on miniscule budgets, will be forced to co-operate with FAIR to avoid having their voices completely drowned out.

If IIROC determines that an external advocacy group should be funded, the primary measure of success should be the achievement of credibility amongst actual retail investors. SIPA, for example, has over 500 members who spend $20 per year on a membership. It is SIPA that should be hiring former regulators for procedural expertise, not the other way around.

Pascutto proposed the concept of FAIR. There was no announcement that the boards of the IDA and RS were considering the concept of FAIR Canada, no competition between different groups for the funding and no consultation with the investing public to determine who was considered best suited to receive this generous grant. The funding may be viewed as a single-source, untendered contract.

> ***If IIROC wishes to improve regulation in Canada, it should fund an organization more likely to criticize it than seek inclusion in its processes.***

What should be done?

A settlement process that does not identify any specific wrongdoing or wrongdoers does not serve the public interest. If a company has done something wrong, it should be penalized, as should the individuals who made and executed the faulty decision. If it has done nothing wrong, it should not be pressured to settle based on fear of adverse publicity and a costly investigation.

Settlement agreements should be banned completely. The public interest is best served by an adversarial process addressing the issues in an open hearing. The investing public will then have a basis for deciding whether the punishment fits the crime, and indeed whether a crime has actually been committed.

Doug Harris of IIROC has advised me that "[it] was IIROC's enforcement position that ABCP was not suitable for retail investors," irrespective of its proportion in the portfolio.

Yet this viewpoint was not reflected in the settlement agreements. IIROC had a clear responsibility to assert its view in a public, adversarial hearing — a responsibility that was ignored.

IIROC should not be able to award grants derived from fines, as this gives rise to a clear conflict of interest. If extra-organizational funding is worthwhile, it should be part of the normal budgetary process; if it isn't worthwhile, it should not be funded.

All revenue derived from fines should be directed to the general revenues of the provinces, with shares determined as part of the recognition orders of the various securities commissions. This would introduce some badly needed accountability to these expenditures.

These changes will take time. In the interim, IIROC should show good faith by directing grants only to those institutions large enough and sufficiently disassociated from the regulatory process to be recognized as fully independent.

A good start would be the endowment of academic chairs at Canadian universities, intended to foster research into the capital markets — particularly those of importance to Canada — and the regulation of these markets. AER

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