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

The importance of portfolio diversification is well known to investment practitioners and academics, but IROC 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.

IROC 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 A1(high)(xsf).

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 IROC 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 IROC levied on Scotia Capital: The ruling cites that one part of the fine 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. IROC 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 Coventrety 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 IROC regarding Scotia’s fulfillment of this action.

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

Problems with “proceeds of crime” laws

The ability of IROC’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.
under this legislation had gone to victims. But there are further prob-
lems beyond the disposition, which are best exemplified by the con-
tinuing debate regarding asset for-
feiture in the United States. One
guide for law enforcement officials
states the primary argument for
supporting “the need for forfei-
ture” as follows: “For many years,
levying large cash fines against
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supporting “the need for forfei-
ture” as follows: “For many years,
IIROC’S SLUSH FUND
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David Harris of the Univers-
ity 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 hav-
ing received “more than 100 inven-
tor complaints” they:
• Did not file 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 influ-
ence 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”: $292,000 to the Canadian Founda-
tion for the Advancement of Inves-
tor Rights (FAIR), with a remaining
commitment of $1.6 million; and
$201,000 to the “Funny Money
project,” with a remaining com-
mitment of $157,000.

After these expenditures, along
with $1.8 million in hearing panel-
related costs and $224,000 on a
Rule Book revision (paid to or dis-
bursed 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 reali-
ties 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 Edu-
cation Fund (IEF), which is funded
by settlements and fines from OSC
enforcement proceedings.

The IEF states, “To be consid-
ered, these initiatives must contrib-
ute measurably to the development
of consumers’ financial and invest-
ment know-how. The expected
results from each program must be
clear and measurable.”

When questioned, the IEF pro-
vided 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%
derstood the concept of compo-
ound growth, compared to just
over 30% before.

It is with respect to FAIR that
an investigation of IIROC’s grant-
ing practices are most interesting.
The founder and current execu-
tive 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 solic-
ted 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 simi-
lar career overlaps and parallels
between these players and the
boards of the two granting agen-
cies, which merged to become

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 pro-
councing its position.

Why have regulators allocated
$3.75 million to form an organi-
ization controlled… continued on page 28

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COMPLIANCE

IROC’s Slush Fund

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by ex-regulators? This is a recipe for groupthink. Such a problem is further exacerbated by the fact that IROC 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 IROC can burnish the perceived success of its funding of FAIR by including FAIR in IROC 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 IROC wishes to improve regulation in Canada, it should fund an organization more likely to criticize than to seek inclusion in its processes.

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

If IROC 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, 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, unintended contract.

What should be done?

A settlement process that does not identify any specific wrongdoing or wrongdoing 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.

Dwag Harris of IROC has advised me that “[i]t was IROC’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. IROC had a clear responsibility to assert its view in a public, adversarial hearing — a responsibility that was ignored.

IROC 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, IROC should show good faith by directing grants only to those institutions large enough and sufficiently dissociated from the regulatory process to be recognized as fully independent.

A good start would be the endorsement 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.

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

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