<u>Securities Enforcement Reform in Canada: If Not Now, When?</u>

Speech by Margaret Franklin, CFA
CFA Institute
The Canadian Club
January 13, 2011

Thank you for your kind introduction, Nick. It's a pleasure to be here today and to have this opportunity to speak to the members and guests of The Canadian Club.

As you know, the recent collapse of global financial markets has underscored many flaws in the financial industry. Whether you are here today as a professional in the financial industry or as an individual investor, you have most likely felt the pain of these past few years in one way or another. It is an unparalleled time in history… one that regulators, politicians, and investment professionals do not wish to repeat. And together we must do everything in our power to ensure that investors are better protected in the future.

We know that there are billions of dollars sitting on the sidelines in cash accounts and yet, despite the performance of 2009 and 2010, investors are still wary of putting that cash to work. Wouldn't you be? Not only did investors experience volatility but they also learned about fraud, egregious breaches of ethics, and a cavalier arrogance where it seemed that capital market participants forgot just whose money it was. Let me be clear, this was not even close to the majority of industry professionals, rather a small but significant and pervasive enough collection that created a perspective for the average investor or perhaps even beyond the average investor of Wall Street and Bay Street, that they had been duped. Given this landscape today, the greatest challenge of the financial industry therefore is to rebuild trust among investors.

Why is trust the desired outcome? From a self-interested perspective for the professionals in the audience, without trust, we don't have a business. We do not produce tangible goods that if found defective, a client can return in exchange for a new one. It is a business whose basic thread is that of trust that we will do the very best for our clients, we are qualified to do the services that we say we can provide and that we will put our clients' interests first and ahead of our own.

For investors in the audience, the opportunity and playing field to earn a fair return is of the utmost importance because much of your financial independence and security now rests on your shoulders. And while there have been no doubt days where stuffing the cash under a mattress probably seemed like a good idea, inflation and longevity, that is, outlasting your investments, are surely two risks that come with doing nothing that in fact make doing nothing untenable.

When I began 20 years ago in the business, institutional investors completely overwhelmed the investment pie. These were sophisticated investors whose occupation was to manage money – it was their livelihood. Over the last 20 years there has been a virtual wholesale transfer of that pie from institutions to the individual where individuals, in one form or another, now control the bulk of the assets. And while much has been written and talked about, individuals have been handed this responsibility with little training, except self-teaching and so they are largely dependent on professional advice. As a result, I would argue that while investing is often seen as elitist and white collar crime is viewed dramatically differently from gun and gang-related crimes, the integrity of and confidence in our financial system is critically important to the well-being of this country and should be as much of a priority as dealing with violence in our communities.

So, if we are to maintain the public's trust in our capital markets and the investment profession, then we in the industry must pay attention to three areas which I'd like to focus on today. First is adherence to high ethical standards. Second are issues of securities enforcement, and third is a call for change. If you remember anything from my time with you today, it would be two words: RESTORE TRUST.

Let's look at ethical standards first. As chair of the Board of Governors of CFA Institute, I have had the opportunity to travel around the world and learn the experiences of global regulators, governments, and industry participants. For those of you unfamiliar with CFA Institute, the organization's mission is to lead the investment profession globally by setting the highest standards of ethics, education, and professional excellence. We are a global community of more than 105,000 members and about 95,000 of our members are Chartered Financial Analysts, a designation the organization bestows to those who have passed three rigorous exams and met other criteria for work experience and references.

Through my experiences as a board member, I propose to you this afternoon that education is the best tool we have for inscribing ethical practices in the bedrock of free financial markets. An ethical framework encourages and promotes trust so market participants can feel confident in the market and invest in fair opportunities. The system must be based on trust between counterparties and trust that the information provided is accurate, relevant, and timely. The first line of defense against the kind of problems we have seen is a living system of professional ethics.

What has happened in many western economies over the past few years is a sorry episode of misplaced incentives gone wild. The credit securitization bubble that burst in 2007 was the result not only of failures in supervision. At heart, it was a series of ethical lapses on a systemic level.

One of our best chances of minimizing ethical lapses in the future comes from the education of investment practitioners, especially young professionals. The next generation of practitioners needs solid grounding in how to deal with inevitable ethical dilemmas. I say this because the complexities of professional ethics are, to a great degree, learned behaviours and habits. An employee faced with quarterly production quotas may not be able to differentiate between his personal interests and the interests of shareowners. A pension fund trustee may not inherently know how to respond to pressures from pension stakeholders to invest in local housing projects. A portfolio manager compensated for performance without accountability to the risk assumed may take outsized investment positions in the pursuit of return, without violating any written rules. These are simple examples of decisions whose answers are not necessarily black and white. These and other ethical decisions become particularly challenging when misplaced incentive systems pull us in the wrong direction.

Getting ethics right is more than simply adopting a code of conduct, although we would argue that commonly-accepted codes of conduct and standards of practice set the bar and offer important signals to investors. There's a lot of room for error and interpretation when professionals are confronted with challenging situations, especially situations that involve large sums of money. On a bigger scale these actions can turn into entrenched behaviours inside firms or industries, especially because much of what happens ethically occurs in a gray area between open, transparent disclosure and dishonest and sometimes criminal intent. Like the old truism, "The chains of habit are too weak to be felt until they are too strong to be broken".

For CFA Institute, the single biggest effect of the financial crisis has been on our role as a global advocate for professional ethics and standards. With the implementation phase of regulatory reform now seemingly at hand, regulatory communities continue to seek our advice and counsel, in large part because we are a non-partisan, multi-constituent organization. Our membership includes portfolio managers, analysts, ceo's and cio's, who come from independent investment managers, large pension funds, banks and other myriad capital market participants all over the globe. Our diversity inherently necessitates clarity on what we speak for, not necessarily on who we speak for and has magnified our reach and ability to positively affect the profession on behalf of our members. We recognize that solutions to the issues of the day are complex and we believe that ethics and professional conduct must be part of the equation.

A 2009 study conducted by The Joint Standing Committee on Retail Investor Issues found that 91% of Canadian investors consider their financial/investment advisor to be among their top-three sources of information guiding their investment decisions. This raises the question: How can we, as industry leaders and participants, best rise to this ethics and professional conduct challenge? To start with, we need to take a hard look at what is and isn't working with the client-advisor relationship.

Obviously, investors count on their advisors to look out for their interests. Investor protection is then a high priority for advisors. It should be the highest priority. With this in mind, advisors themselves must ensure they invest themselves continually in understanding new market dynamics, new market instruments, and how the changing environment affects their fiduciary responsibilities to clients. There must be a commitment to professional excellence and ethical standards that goes beyond lip service. It is no coincidence, then, that anyone wishing to earn and benefit from the CFA designation must master our Code of Ethics and Standards of Professional Conduct at all three exam levels. They also must sign an annual professional conduct agreement or forfeit their right to use the CFA designation. Because of this rigor, regulators in many countries increasingly require passing of CFA exams as a pre-requisite to be licensed to practice as an investment advisor.

On the other side of the coin, investors need to do more to educate themselves about their investing decisions. With the shift in Canada's pension structure from defined benefit plans to defined contribution plans, millions of Canadians are now in charge of their own financial retirement. Now, more than ever before, Canadian investors need to better understand the financial industry, read the reports they receive, and seek the services of highly qualified advisors. Just as advisors are bound by *Know Your Client* rules, investors must also do whatever they can to *Know Their Advisor*. In my own practice and in the shared observations of other private client advisors, I would remark that investors are ripe for the candid conversation including the creation and management of realistic risk and return expectations. However, they are demanding that this conversation be in a language that is both comprehensible and relevant to them, not in the professional lexicon.

Still, even the most diligent investor can be caught off-guard by a rogue advisor, and when this happens enforcement becomes essential. This takes us to the second area I'd like to address. While investor education and ethical professional conduct are our best hope for investor protection, the threat of punishment for breaking rules or principles also deters a fair amount of unethical behaviour on the part of advisors. The reality is, however, that there will always be "bad guys" whose ethos are skewed in their own favour. And when practitioners do wrong, either by making bad choices in dealing with ethical dilemmas or surrendering to the worst impulses of human behaviour, then speedy, just enforcement and penalties must result.

As a native Canadian, it's only natural that my frame of reference for interactions with colleagues in different countries is my experience here in our country. Sadly, when it comes to the issue of enforcement, the Canadian experience is poor. The serious remediation and enhancement to enforcement efforts in many countries is reason for optimism… I'd like to share an example we all know too well. The Bernie Madoff example is an extraordinary one, and not just for its scale. An industry practitioner, and a CFA charterholder I might add, was asked to look at Madoff's returns eight years ago because they were competitors and they couldn't make sense of the return profile. In his analysis, he came to realize that indeed the return profile was impossible. What ensued was a thorough and forensic-like investigation that culminated in three detailed written submissions to the SEC, each of which was ignored. This gentleman's greatest regret is that in 2004 he didn't find a different way to grab the SEC's attention because billions were lost between 2004 and 2008 when Madoff was finally shut down. We all know how this one ended. Within two years Bernie Madoff was tried and sentenced to 150 years in prison and his family and estate face decades of civil litigation. With our neighbours to the south, who do love a perp walk, their attorney generals, particularly in New York State where Wall Street dominates, are keenly and confidently focused on retribution. Who'd have thunk Bay Street would be more familiar with Eliot Spitzer and Andrew Cuomo than the Ontario Attorney General, if they even know his name. We are not focused on it here. So when I return to Canada, it is hard not to be frustrated.

The framework in our country is hardly preventative either. Consider the outcomes for investors when these mistakes were not caught in time to prevent or lessen the loss:

- In 1997, when Bre-X collapsed, the Quebec public sector pension fund lost $70 million; the Ontario Teachers' Pension Plan lost $100 million; and the Ontario Municipal Employees' Retirement Board lost $45 million.

- "As a direct result of the government ignoring red flags in 2001, over 33,000 Crocus investors lost over $60 million dollars." [*National Post*]

- In 2005, the Norbourg scandal cost more than 9,000 investors millions of dollars.

- Approximately 26,000 clients were defrauded of $750 million of their savings when the Toronto hedge fund Portus Alternative Asset Management failed.

And the list goes on and on.

Cases such as these cause the industry as a whole to suffer as a result of a tainting of the pool and eroded investor confidence. I continue to be shocked that industry participants aren't outraged and demanding stronger enforcement because this is about our business, which is about trust.

Now let's consider the enforcement of, or punishment for, bad behaviour. A prime example is the case against the former managing director of RBC Dominion Securities, Andrew Rankin. After all the resources poured into this case over a period of seven years, you have to wonder how the result – that the OSC decided not to re-try the case against Rankin – can be justified when the co-accused, Daniel Duic admitted his wrongdoing while testifying to Rankin's, but neither went to jail. Indeed, Duic, in a deal cut with the OSC, got to keep a portion of his profits and Andrew Rankin is now suing RBC for wrongful dismissal. And while both have been banned from the securities industry in Canada, it does make one wonder whether the course of events in this case adequately sent the message that the misuse of confidential information will be treated seriously.

So why can't Canada get the bad guys? I'd like to submit four significant reasons:

1. There are <u>too many players on the field</u>. Securities regulation in Canada is currently in the hands of 13 provincial and territorial securities administrators and two SROs. The perception is that these securities administrators have a tendency to let white-collar crime go unpunished.
2. We don't have enough sufficiently qualified people with adequate industry experience to find, investigate and convict wrongdoers.
3. Where there is clear responsibility for regulation, there is inadequate bite to the bark; and
4. There is an insufficient ability to coordinate and collaborate in efforts to catch the bad guys.

So what can Canada do to turn this situation around?

First, we can adopt a single, national regulator that will help streamline detection, investigation, and disciplinary proceedings. I say this with the full understanding that making this kind of change involves delicate Constitutional issues that require careful consideration that has and is taking place before any structural change can be made. However, a fragmented regulatory framework is an environment ripe for regulatory arbitrage. I would commend Finance Minister Flaherty for his determination in attempting to make this happen, given the subtlety of its importance to the average Canadian in the context of everything else going on, the vehement opposition by a small but nonetheless influential group, and the small amount of political currency he and his party will win by doing this. It is one of the rare instances where the right thing appears to trump the politically expedient thing.

The second inability to get the bad guys is not having the right people in the right structure. In 2003, the Royal Canadian Mounted Police launched the Integrated Market Enforcement Teams, or IMET, which is comprised of 10 investigative units in four cities across Canada. IMET is described in its annual report "to be a group of highly specialized investigators dedicated to ensuring that those who commit serious capital markets fraud offences will be discovered, investigated, prosecuted, and incarcerated in an effective and timely fashion." IMET has cost Canadian taxpayers more than $100 million. To March 31, 2009 (the most recent data available), 26 individuals have been charged with 1,008 counts of capital markets fraud offences. The results over seven years: five convictions at a cost of more than $100 million to Canadian taxpayers.

Our second recommendation is that this agency needs to be revamped from top to bottom.

When we look at enforcement investigators employed by provincial administrators, it is striking how many have limited experience with the industry or many of its practices.

For example, too many investigators employed by regulators here and nationally are former, even retired law enforcement staff with negligible backgrounds in the securities industry. Obtaining the Canadian Securities Course should be a *minimum* requirement for this type of employment. Add to this the fact that there aren't enough securities lawyers with industry experience – particularly those with compliance backgrounds – working at the senior-most levels of the provincial securities administrators.

So it is just the notion that CFA, in the interest of increasing regulator literacy globally, has discount programs available that offer the many benefits of the CFA program body of knowledge. We are currently operating this program with the U.S. Securities and Exchange Commission and we are pleased to announce today that we will offer a similar program to Canadian regulators across the country.

Finally, we must increase penalties and ensure fines are collected. It's a fact that enforcement penalties frequently go uncollected. Fines and penalties are often ignored by industry professionals convicted of securities regulation offences. The MFDA, for example, collects only 38% of penalties while IIROC is successful only 20% of the time because people simply leave the industry at least temporarily, to avoid paying the fines. We are highly cognizant of this shortfall as we too at CFA Institute face the same issue when individuals facing disciplinary hearings or sanctions – including revocation of the charter - often remove themselves from CFA membership. We believe, however, in both cases, with the goal of enhancing enforcement, IIROC and the MFDA should be granted the statutory ability to collect fines…and of course, this would be greatly facilitated by a national single regulator.

Sadly, none of these recommendations are new. In 2006, five years ago, each of these very recommendations was eloquently and plainly articulated in the 2006 commissioned report "Task Force to Modernize Canada's Securities Legislation". I would encourage anyone interested in this area to read this report. It's exceptionally well-written, thoughtful and sensible. The "Enforcement Section" contains 33 enforcement-specific recommendations. Of these, very few have been implemented or are even under serious consideration. I find this very disheartening.

In the midst of this dreary picture, I would like to congratulate the OSC's new chair, Howard Wetston, who recently pledged to make enforcement a top priority during his term. We are strongly behind you, Mr. Wetston.

I can only hope that his counterparts in the rest of the country will follow suit. Our provincial securities administrators need to step up to the plate, acknowledge there's a problem and start seeking solutions.

Our investors deserve nothing less.

So let's look at next steps:

1. CFA Institute will be calling for a federally commissioned task force to create the awareness and political will to resolve these issues. We are inviting others in the

industry who share our interest in regaining investor trust and confidence by enhancing enforcement practices to join us in the push for this task force.

The CFA Institute, consistent with its mission of professional excellence through education and ethics training is, as of today, making available to Canadian regulators across the country the same discount programs that offer the many benefits of the CFA program body of knowledge.

For those professionals in the audience we will be calling on you to help us restore trust. For the investors in audience, we will earn that trust back.

I would like to end essentially where I began, that restoring trust after years of market integrity devastation is the greatest challenge facing leaders of the financial services industry, regulators, politicians, and investment practitioners. I recently had lunch with Jason Zweig of *The Wall Street Journal*. Jason writes frequently and is the author of a number of books on investing and the individual. And given our day jobs, our conversation inevitably turned to this issue of trust in its myriad forms. He brought to my attention an utterly fascinating piece of research about victims and functional responsibility and it goes something like this: When something bad happens to someone, the victim will often rethink the events and start to assume some responsibility. Maybe I shouldn't have been walking out that late at night, or on that deserted street? And it helps us think that the world does operate to a reasonable social order. We explored this analogy as it relates to our business. Investors in the tech bubble could comfort themselves that all was as it should be because their brokers had told them not to put all their eggs in one basket, commentators were howling at the stratospheric valuations for businesses with no revenues. So fast forward 10 years. The challenge is that people did diversify, they did what their advisors told them, they largely held on. And they have watched unparalleled lapses in ethics, fraudulent activity on an unheard of scale, and a host of other violations. If we don't act now, investors will begin to turn the notion of functional responsibility on its head and believe that good things happen to bad people and bad things happen to good people.

It is in our self interest and our clients' best interests that we find the perspective and fortitude to strengthen securities enforcement and restore trust. Because if not now, when and if not us, who.

Our vision is that financial markets should be equitable, free, and efficient so that every investor has a chance to earn a fair return. I hope you will join me and my colleagues in stewarding this vision and protecting investors at home and around the world.

Thank you for this opportunity to speak with you today.

# # # # # # # #