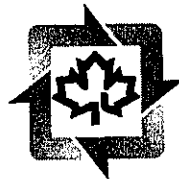


# **The Future of Self-Regulation**

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Check against delivery.

Thank you, Jim. I appreciate those kind comments.

Good afternoon. I am delighted to be here.

I want to talk about the rapidly changing global market environment, and the challenges it poses for regulation. Regulation is becoming increasingly costly, and it needs to be increasingly efficient.

In Canada, considerable debate has been focused over the past couple of years on the structure of securities regulation — either the proposal for a national securities commission or a harmonized regulatory structure. Those regulatory proposals largely deal with disclosure, regulations and enforcement.

Today, I want to talk about the way we govern the *business activities* of securities firms — the self-regulatory regime that, frankly, has proven to be the most efficient means of regulation.

Governments and regulators here in Canada are examining the role of self-regulation in light of increased public expectations for investor protection. One of the central issues is how to preserve the fundamental nature of self-regulating organizations, or SROs, while ensuring the public interest always ranks first.

Balance is essential. With it, self-regulation can help address regulatory problems — and reduce the costs to the economy.

Regulators must certainly deal with a changing environment. Consider some of the transformations we are seeing in the market.

We are seeing continuing global integration, with new products becoming accessible to a wider investor base.

We are seeing rapidly innovating products and markets – including the increasing popularity of alternative investment funds, the use of complex structured products, and wider use of derivatives.

We're seeing increasing mass participation in investment vehicles that used to be the preserve of institutional investors and high net worth individuals.

All of these changes in the investing environment are adding to a growing regulatory burden, as regulators seek to cope with the challenge of increasingly diverse and complex products.

Business leaders in most markets feel that the overall regulatory burden has become pervasive, intrusive, expensive, time-consuming, risky and distracting. Many corporate leaders believe that the burden of regulation has become so great as to constitute a serious detriment to global economic growth.

That is the regulatory challenge that markets face. What is the impact of the growing burdens of regulation? It is cost and inefficiency.

The cost of regulation eats into profitability. And it isn't just a matter of the quantity of regulation. The challenge is also its quality. Too often, rules are imposed that are bureaucratic rather than targeted to issues that pose a significant risk to the system or its investors.

Gaps in regulation can lead to increased risks and costs for the investing public.

What we are looking for in securities regulation is balance. A market that is under-regulated could fail to properly protect investors – prompting them to take their capital elsewhere. But a market that is over-regulated could easily stifle growth, innovation and efficiencies.

What kind of regulatory model meets the needs of the market? “Balanced regulation” – not too loose and not too rigid. Balance.

Let me give an example: the growth and proliferation of hedge fund products in the retail marketplace. We need to address it – without overreacting to it. The IDA has been conducting a study.

In raw numbers, Canada’s hedge fund market might not seem that big. It’s estimated at somewhere between \$15 billion and \$20 billion in assets, half of which is in fund-of-fund and principal-protected product primarily targeted to the retail investor. That is a small fraction of the trillion-dollar global market. But the growth rate of the hedge fund sector in this country is a compound 40 percent a year over the past five years.

The market is not just growing in volume; it is growing beyond its traditional base of institutional and high net worth investors that satisfy accredited or sophisticated investor rules. Hedge funds and related products have entered the retail marketplace. An entire universe of hedge fund related products have increasingly been created and marketed to retail investors, who can access them without the large initial investment requirements.

By itself, this is not a bad trend. Hedge funds make an important contribution to liquidity and to the capital-raising process. They can serve to better diversify the investments of Canadians and improve their risk-return trade-off.

The real question is not whether hedge funds should be available to Canadian retail investors. The question, which the IDA has been studying, is: What reforms are needed to the regulatory system to help investors and their advisers better understand the risks and opportunities of alternative investments? We need to make sure that sophisticated new products are applicable to retail investors – not out of their reach.

This is an example of the “Balanced regulation” needed to maintain market integrity and confidence – targeted and informed regulation that fills existing regulatory gaps, and fills them quickly.

Can a self-regulatory organization provide that fine balance?

The model certainly meets the most important criteria in a time of rapid change – flexibility and responsiveness to innovation. In fact, there are some important advantages that are inherent in self-regulation – qualities that benefit the investing public.

The investing public benefits from an SRO’s up-close understanding of how the market works. SROs provide a vehicle for applying an industry’s expertise to policy areas that are complex and rapidly changing.

When dealing with specialized, technical issues, professionals in the field can answer the toughest question: How will it actually work in practice?

The investing public benefits from the flexibility and market responsiveness that self-regulation can offer. A good example is the new and innovative financial products that I was discussing. It makes sense to draw on the expertise of experienced professionals who have a direct incentive to deal with problems before they become crises.

The investing public benefits when an industry is on-side with the regulatory regime that governs it. Ensuring broad compliance depends on building a sense that regulations are fair, balanced and rooted in market reality.

The investing public benefits financially from self-regulation. Let's not forget that self-regulation is also *self-funded* regulation. The costs are not borne by taxpayers – but by the industry. And the industry has a strong incentive to protect investors. Not only is it essential to investor confidence, but keep in mind who bears the cost of protecting investors if an IDA firm goes insolvent. It's investment dealers, through their contribution to the Canadian Investor Protection Fund.

The numbers tell the story. You can see the cost benefits of self-regulation by looking at the IDA budget. One hundred per cent of the organization's costs are borne by the securities industry – while 85 per cent of its budget is allocated to compliance, enforcement, and policy development.

Self-regulation of the securities industry also offers a couple of advantages that are unique to Canada.

When you think about it, it is the only national form of securities regulation that we have. Without it, our regulatory regime would be even more balkanized.

Take one example: The IDA's business conduct rules. The IDA offers one rulebook, and it applies across the country. It is highly unlikely we would have one set of rules if 13 decision makers set them.

We have largely eliminated the conflict between market ownership and regulation. SROs in Canada have been able to avoid the complicated and rather extreme remedial steps of multiple boards or the complete removal of industry from our boards. This

stands in contrast to the U.S. system of self-regulation, where the issue of independent businesses nested within both SROs, the NYSE and NASD, has again drawn the attention of the SEC. The IDA provides the advantages of a U.S. SRO, without that baggage.

These are all good general advantages to self-regulation. But how does it play itself out in dealing with specific emerging issues? Let's take a look at how we have addressed the issue of hedge funds offering retail investment products.

As I mentioned, the IDA has been conducting an extensive study of the issue. We have issued a detailed report, with specific recommendations, including prohibiting "off-book" transactions, referral arrangements, due diligence and standards regarding disclosure, conflicts of interest and internal controls.

The report also advocates bringing hedge funds offered to the retail investor fully within the regulatory system.

While one may differ with specific recommendations, and find something to add or subtract, this is unquestionably an example of an SRO dealing with an emerging issue, dealing with it quickly, and dealing with it in a fair, balanced and innovative way.

Some may have a concern about self-regulation. How can an industry be counted on to regulate itself? In Canada, self-regulation of the financial services industry goes back longer than governmental regulation. The IDA was recognized by provincial securities commissions as an SRO in the 1990s. But for 80 years prior, it had been a regulator of Member firms. That adds up to 90 years of self-regulation in a capital market that has earned a global reputation for fairness and efficiency.

Nonetheless, the public has to be assured that on any issue where there may be a conflict between our Members' interests and the public interest, it is the public interest that will prevail.

How do we safeguard the public interest? How do we regulate a financial world that is continually changing - while steering clear of potential conflict?

We rely on a series of checks and balances, including public directors on our Board. I cannot think of a single instance in which the majority of public members have been outvoted on a matter of policy.

Public directors sit on all our governance committees -- including the executive, audit, and regulation oversight committees.

Let's keep in mind we are not a regulatory island. The regulatory authorities must approve public interest by-laws, after publication for public comment.

And under the terms of recognition, the IDA is subject to oversight by the securities commissions.

Our internal checks and balances include periodic reviews by outside authorities.

Certainly there can be no question of our commitment to enforcement, and providing the resources it needs. Over the past five years, our enforcement budget has grown by 90 per cent and enforcement staff has increased 20 per cent.

These are valuable safeguards. I would like to put forward several other ideas that have been developed -- ideas that can make the self-regulating model even more suitable.

First, we should focus to a greater extent on the regulatory principles we believe in, rather than the specific rules. I suppose that dotting a lot of "i's" and crossing a lot of "t's" provides a sense of security – but does it meet the needs of investors and the marketplace?

In fact, the "regulate by numbers" approach can be costly and confining. Once again, we have to achieve the right balance. By making regulatory principles clear – and buttressing that with robust enforcement – we can push compliance down to registrants and marketplaces.

Second, in the area of sales compliance, we have implemented a risk-based model that is less costly and less intrusive, offering a lighter regulatory load on issuers, intermediaries and registrants who are known to be compliant and can be monitored less frequently.

Third, it is important to always keep in mind that the bedrock of effective regulation and investor confidence is enforcement – tough, but fair, enforcement. Our commitment to providing resources for enforcement speaks for itself.

Fourth, rule-making must be informed – based on thorough industry knowledge and analysis. It is vital to collect the data, conduct the surveys, and carry out the analysis.

Self-regulation has played a central role in the regulation of the securities market in North America and many other developed markets around the world.

It builds on core strengths, including practical understanding of how regulations operate on the ground, and the ability to achieve regulatory objectives effectively and efficiently, with minimal collateral damage.

Furthermore, the industry has one of the best motivations to effectively police itself – it's good business.

Markets are key to economic growth – and effective regulation is key to efficient markets. Self-regulation has been an important part of that in the past – and it can be an even more valuable tool in the future.

Thank you.