

COMPLIANCE CONUNDRUM

WATCHDOGS TIGHTEN THE NOOSE ON REGULATION.

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A decade ago, Canada was for errant brokers and dealers what it is today for copyright violators—a safe haven—mired in provincial politics, and always managing to stay under the compliance radar.

Canada's securities industry traditionally treated regulation as a local matter, with each province and territory behaving like a fiefdom, addressing and protecting its own. As capital markets became more national and international in scope, the regulation systems stayed stubbornly provincial.

Former OSC commissioner Glorianne Stromberg says it's odd that the Canadian financial services industry was the one industry that was seemingly not driven by its clients' needs. Most such industries would go out of business if they didn't strive to better serve their clients.

Such dogged provincialism has not, however, always been the

norm in Canada. Take the railways, for example, which went from as many as nine different gauges in the 1860s to a nationwide standard in the twentieth century. Today, from a regulatory standpoint, the finance industry needs to loosen its grip on the multiple-gauge mindset and adopt standardized compliance.

According to the Ontario Securities Commission (OSC), of the 103 countries (including 20 with federal political structures) represented in the International Organization of Securities Commissions, only two lack national securities regulators—Bosnia and Canada—a dubious distinction for a G8 nation.

Winds of Change

With the turn of the millennium, territorial harmonization is once again a buzzword. The complexion of the Canadian capital markets is changing, even though provincial

jurisdictions continue to have competing visions of how markets should best be regulated.

Alex Popovic, vice-president of enforcement at the Investment Dealers Association (IDA), believes regulation has taken a tremendous leap forward. "When IDA came into being in 1916, it was just a group of bond traders who got together on Bay Street to chat about common issues. It has since evolved into one of Canada's senior SROs," Popovic says, adding that over the past decade, the IDA has moved from being an association that merely represented a membership to a well-respected regulatory body.

The change is evident in its staffing structure, he says, where the IDA has grown from a paltry three-member enforcement staff in 1997 to a hearty community of 85 officers today. Director Jeff Kehoe remarks that growth is also a reflection of **continued on page 22**

continued from page 21 the markets which have gone from insulated compliance to a robust regime based on investor protection and the integrity of the capital markets. “I don’t think anyone would have uttered those phrases 10 years ago,” Kehoe says. “And now they are the mantra of all commissions across Canada—religiously uttered in speeches, mission statements and mandates.”

The establishment of the Mutual Fund Dealers Association (MFDA) in 1998 has been another crucial step toward ensuring more stringent compliance for advisors selling mutual funds. Karen McGuinness, MFDA’s vice-president of compliance, says when the self-regulatory organization (SRO) was established there was a lot of concern in the industry about the potential impact of heightened compliance. Says McGuinness: “There was concern that MFDA would mean we are pushing the industry into an IDA model. There was apprehension that we were creating an advantage for larger firms, which are better able to spread regulatory costs over a larger base.”

That concern exists, says Popovic, but it is ill-founded given that the Canadian Securities Administration (CSA) now requires a thorough cost-benefit analysis of any rules. “Over the past 10 years, there is heightened appreciation of retail clients as opposed to institutional investors.”

Some still perceive compliance as an expense that interferes with advisors who want to build their books. McGuinness, however, believes that firms that don’t value compliance will not survive.

“Besides, the playing field has been levelled, she says. “There’s a cost there, so the firms that were doing things right feel like their competition has to do it too now.”

New Heights

Stromberg agrees there is heightened awareness that financial service providers must invest to meet compliance and regulatory requirements. She believes the most positive change to come out of the past decade is the requirement that all dealers selling securities (other than exempt securities) are now required to be a member of an SRO.

However, Stromberg views the MFDA as a stopgap measure and argues it leaves many activities that are carried on by its members unregulated, such as the sale of segregated funds and other insurance products wrapped around investments.

Prema Thiele, partner at Borden Ladner Gervais in Toronto, says another positive of the regulatory reforms of the last decade is that more firms are adopting a risk-based approach to compliance, which “goes hand-in-hand with a principles-based approach.” She strongly favours the principles-based regulation, as opposed to the prescriptive approach used in the U.S. “Registrants need to perform their own internal assessments in developing compliance systems that suit them best. What fits [at] RBC Dominion Securities may not fit a one-person investment dealer,” Thiele explains.

“It’s difficult to deal with every tiny thing that is out of line. We need to focus on the high-risk offenders, and prioritize where regulatory resources should be deployed.”

The one thing that regulators are universally focusing on is client-advisor relationships. With heightened risk of prosecutions looming over them, the retail brokers’ mindsets are changing fast. Unlike five or 10 years ago, they no longer treat Know-Your-Client forms as pieces of paper. Most advisors, however, still regard them as an odi-

ous formality, unless of course there’s a dispute. Stromberg notes when that happens they’re viewed as the key to an advisor’s exoneration: “Many clients are unaware of the existence of the Know-Your-Client form, or of its importance, until it is used against them.”

National Direction

According to a government-commissioned report by Columbia University Law School professor John Coffee, at present, Canada loses about \$10 billion in economic output each year because of its fragmented securities regulation.

Further, a study conducted by the IDA found that adopting a single national securities regulator would save the brokerage industry \$73 million a year directly, not including intangibles and potential indirect costs.

Despite periodic reforms, the existing Canadian regulatory patchwork can be a deterrent to foreign investors who compare it to single-regulator structures in their own countries. Stromberg says, in terms of initiatives, despite the OSC’s push toward stronger regulation, Canada has failed to establish an integrated financial services agency. She recommends streamlining laws and regulations across the country to simplify financial planning challenges relating to wills, estates, powers of attorney, pension plans and the like. She also feels there is need for enhanced education and proficiency requirements for industry participants; and a publicly searchable register of complaints and regulatory actions against financial services participants.

Forward March

Globalization, technological changes and consolidation are the key challenges facing the Canadian securities industry today. Proximity to the U.S., the rela-

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tively low barriers to entry for foreign securities firms, the advent of alternative trading systems, and new entrants such as NASDAQ have made the Canadian securities business very competitive.

In this fast-paced global environment, Canada's relatively tiny capital market (approximately 3% of transactions worldwide) must compete for attention in bringing capital-seeking companies together with investors, so that they can transact business efficiently at the lowest possible cost. Effective compliance is an essential part of making sure that our markets can attract competitively priced risk capital.

While Canadian investors are bearing the cost of maintaining 13 sets of provincial and territorial securities regulators, there are competing views about pushing for a national regulator. One stream of thought warns that a national regulator could lead to monopoly and complacency.

In its enthusiasm for nationalized regulation, which encompasses the regional differences of the provinces, Canada needs to steer clear of the temptation to over-regulate, thereby imposing needless costs on investors.

At the same time, it needs to be careful that rogue regions don't engage in a regulatory race to the bottom, seeking to eliminate necessary safeguards in the quest to reduce costs.

According to Thiele, this can be achieved by a principles-based approach, which asks companies to be ethical to their cores, rather than focusing on technical requirements. "If a company is generally conforming to the principles, but violates a rule in a way that does not harm the public, we should take that into account," she says, adding that, ideally, "what is good for one Canadian should be good for another." **AE**

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