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General Counsel's Office
New Self-Regulatory Organization of Canada
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> **Distributing Funds Disgorged and Collected through New SRO Disciplinary Proceedings to Harmed Investors Consultation.** https://www.iiroc.ca/news-and-publications/notices-and-guidance/proposal-distributing-funds-disgorged-and-collected-through-new-sro-disciplinary-proceedings-harmed

Kenmar is an Ontario-based privately-funded organization focused on investor education via articles hosted at www.canadianfundwatch.com Kenmar also publishes ***the Fund OBSERVER*** on a monthly basis discussing consumer protection issues primarily for retail investors. Kenmar is actively engaged with regulatory affairs. An affiliate, Kenmar Portfolio Analytics, assists, on a no-charge basis, abused consumers and/or their counsel in filing investor complaints and restitution claims.

Kenmar Associates appreciates the opportunity to comment on the proposed Disgorgement Distribution Program. Kudos to the Working Group (WG) for providing a comprehensive plain language background, situation analysis and explanation of the proposed Program. That being said, we recommend that in future, such WG's include some representation from consumer groups and/or informed consumers. In this specific consultation, we expect the NewSRO Investor Advisory Panel will submit a comment letter.

> **Key takeaways** A hearing panel may order disgorgement of any amount obtained, including any loss avoided, directly or indirectly, as a result of the regulatory contravention. A disgorgement penalty can, in principle, be imposed even if the investor(s) did not suffer losses due to the misconduct. Disgorgement cash received is to be placed in the Restricted Fund (RF). There would be a designated branch or designated employees of NewSRO to carry out the function of the Program administrator. Given the broad definition of disgorgement, it will be difficult for most retail investors to assess the correct amount of disgorgement to claim. If the Program is too complex and burdensome for investors, it likely will fail to achieve its prime objective.

Disgorgement distribution has value for investors especially since OBSI is not empowered to make binding investor compensation decisions. We are not aware of any statute of limitations period related to disgorgements but have been informed it is 5 years for the U.S. SEC. Based on the consultation paper ,disgorgements are not subject to interest charges if not paid within a certain timeline.

We note that the cycle time to investigate an alleged breach until a hearing panel decision is made can be in excess of 2 years. Any process improvements NewSRO can do to reduce enforcement cycle time would make the Program more impactful and enforcement more credible.

As a general rule, we expect NewSRO enforcement decisions to prioritize investor compensation over fines. Empirical IIROC research reveals this is the investor preference and expectation. This prioritization will have a superior deterrence impact AND would be in the Public interest.

Introduction

We are informed that between April 2009 and December 2022, IIROC's hearing panels ordered just $7.9 million in disgorgement in 77 enforcement cases and collected about $1 million in disgorgement. This yields an average amount available to harmed investors for distribution of the order of $75 -80K average per annum. (NOTE: According to Appendix 3 in the consultation, in just 3 years of the 14 fiscal year periods presented did the disgorgement collected exceed $36K) To this we would add the amount recouped from Dealers and any disgorgement amounts resulting from MFDA sources. A high end guess would be $400K p.a. average for NewSRO. This could change if the CFR regime reduces the amount of Member wrongdoing and NewSRO diligently enforces the new conduct rules.

We are disappointed to learn that the New SRO Restricted Fund is reserved for limited purposes enumerated in the New SRO Recognition Orders, which do not include payments to harmed investors. We had specifically supported NewSRO to avoid well identified issues like this. All our input to the CSA stressed investor compensation as a priority - the very definition of investor protection. IIROC research also provided evidence that investors were taking the time to complain to IIROC because they were seeking compensation for the wrongdoing committed by Member Firms or their representatives.

The consultation paper expresses a concern about shifting the focus of the enforcement process from prevention and deterrence of misconduct to investor compensation (which it asserts investors should pursue in other fora such as OBSI, arbitration or. Civil court). For us, investor protection/regulation means protecting investors from harm/ undue losses.

We are of the firm conviction that investor compensation is a potent deterrent especially when both the Member Firm and the Firm's representative are held to account and must face their client's dissatisfaction directly. Making a direct connection between a breach of law and a harmed client impacts reputation which Firm's want to protect and preserve at all costs.

The Ontario Task force to modernize securities regulation recommended that OSC disgorgement orders be distributed to harmed clients:

> **Enhancing investor protection**
> **46. Require that amounts collected by the OSC pursuant to disgorgement orders be deposited into court for distribution to harmed investors in cases where direct financial harm to investors is provable**
> *A statutory process to support the distribution of disgorged funds to harmed investors is important for investor protection in Ontario and is vital to the trust and*

confidence people have in the capital markets and in the OSC's enforcement capabilities. It is important that ill-gotten gains recovered through the OSC's collection efforts be distributed to the investors who were harmed, as investors may not be able to independently recover from the respondent. , In fact the OSC has used a Superior Court appointed receiver to distribute funds disgorged to the OSC in two test cases.

There is a unique opportunity here for NewSRO to bring modern thinking to its enforcement practices and philosophy of protecting investors from its Member Firms breaches of law, incompetence or negligence. This requires a change in culture (organizational DNA) from the old ways.

Commentary

Kenmar generally support the initiative to provide disgorgement cash to all eligible investors. After all, it is the investor whose money which is at stake.

Basic question

We start with a question. Should Dealers be required to inform all victims of their or their authorized representative's breaches? We believe they should so that clients are empowered to self-identify and seek compensation if and as appropriate. Based on our experience, notification letters initiated by Dealers are misleading and unclear .See *When you receive a letter from your dealer*.... http://www.canadianfundwatch.com/2020/03/investor-alert-when-you-receive-letter.html . Too often we find these communications confusing and hard for the average retail investor to comprehend. This notification of breach to investors needs to be overseen by NewSRO.

NewSRO needs standard for calculating and disclosing disgorgement

We note that no disgorgement figures were provided for the MFDA. This is because they subsume the disgorgement component into the overall sanction amount. **Accordingly, the MFDA sanction rules should be amended to ensure that disgorgement is an isolable, readily identifiable sanction.**

The definition of disgorgement (includes direct or indirect financial benefits, i.e., ill-gotten profits, fees or commissions wrongfully obtained, and loss avoided by an advisor or a firm.) is broad, making its calculation sometimes less than precise, except in straightforward cases. Further, MfDA allows hearing panels to impose "a fine not exceeding the greater of: [...] (ii) an amount equal to three times the profit obtained or loss avoided by such person as a result of committing the violation although this amount is subsumed in the global monetary sanction and not disclosed separately to the public .This appears to be materially different than IIROC's approach which determines disgorgement using their calculated amount without a multiplier. **We recommend that NewSRO provide detailed guidance on standardized best practices for calculating disgorgement amounts and how to fairly allocate dollars to impacted investors.**

Commissions and fees are typically shared between the Dealer and its representatives. The amount disgorged from the representative represents only a fraction of the ill-gotten gains. **The amount of disgorgement by the hearing panel should be the full amount which would include the improper portion of ill-gotten gains retained by the Dealer resulting from the misconduct committed by the Dealer's representative.** These are dollar amounts resulting from an illegal act and therefore should not be retained by the Dealer.

The enforcement-investor compensation link

If the investor compensation process is distinct and separate from the enforcement process i.e. investor claims for compensation are considered in a separate hearing at the conclusion of a disciplinary proceeding, the cycle time should be very short so that impacted investors have access to disgorgement cash as soon as possible.

Whether or not impacted investors complained to New SRO or provided witness testimony at a disciplinary hearing, these investors should be eligible to receive payments under the program .In many cases, retail investors impacted by wrongdoing are unaware that rules were broken or that their adviser has been sanctioned.

The Working Group recommends that the class of eligible investors be limited by the parameters of a particular enforcement action (i.e., relevant time periods, issues raised in the proceeding, etc.). This does not appear to be unreasonable but we point out that the correlation may not always be easy for Panels to validate. We expect NewSRO to err on the side of the investor where a legitimate question arises.

NewSRO enforcement should prioritize collection and payment of disgorgement over its collection of penalties and costs. It is our understanding that the U.S. Financial Industry Regulatory Authority (FINRA), a self-regulatory organization like NewSRO, mandates that its adjudicative tribunals and staff put their highest priority on compensating investors for any harm caused by investment firms.

What about uncollected disgorgements?

In our view, any uncollected disgorgement cash from the Dealer's authorized representative should be to the account of the Dealer. See **Ref** *G20/OECD High-Level Principles on Financial Consumer Protection 2022* which Canada endorses. https://www.oecd.org/daf/fin/financial-education/G20_OECD%20FCP%20Principles.pdf#:~:text=The%20G20%2FOECD%20High-Level%20Principles%20on%20Financial%20Consumer%20Protection,an%20effective%20and%20comprehensive%20financial%20consumer%20protection%20framework . Under Principle # 9 **Financial services providers should also be responsible and accountable for the actions of their intermediaries.**

NOTE: In any event, the Dealer's share of the ill-gotten commissions, fees and profits derived from a Dealer Representative's misconduct should ALWAYS be collectible by NewSRO. Indeed, the account agreement is between the Dealer and the client.

Notification of investors

We are glad to see that the Program Administrator will be required to inform affected clients of the Firm/Rep in writing of the availability of disgorgement cash. This communication should be very clear, in plain language.

Under the proposed Program, after New SRO disciplinary proceedings are concluded and funds are disgorged and collected, a notice would be provided to all known eligible investors, either by direct notice to investors or, in more complex cases involving large amounts or a large group of claimants, a public notice. We do not see why complex cases would not involve direct investor communications. Retail investors do not typically seek out a public notice, so in effect they would not be notified.

If despite our recommendation to the contrary, NewSRO concludes that it is in the best interests of harmed investors to compel them to file a formal claim, a generous response time should be provided. Given the financial and other stresses average Canadians are facing today, a 30 -90 day period is too aggressive. **We recommend that the opt in time for claims be no less than 90 days after receipt of notice, preferably longer** .We assume that the Dealer's disclosure of victim's addresses, phone numbers and/or email addresses is not offside with applicable privacy laws.

We suggest that if, say 180 calendar days, have passed since the hearing panel decision and the disgorgement has not been collected and/or NewSRO does not intend to pursue collection in Court, the disgorgement shall be deemed to be uncollected. The disgorgement would thereafter not be part of the Program. Any investor compensation by the Dealer or other entities, such as OBSI, should factor in fees, commissions and related expense charges incurred in their loss calculations without reservation.

Harmed investors must file a claim, why?

In order to receive the disgorgement distribution, the Proposal requires victims to make a claim for the disgorgement. To make a claim through the Program, Eligible Investors would need to provide sufficient documentation confirming their identity, disclose any other proceedings they may have pursued to recover the same losses and prove the amount of their claim. Why have to file a claim? Surely, NewSRO knows which investor accounts were impacted by the breach because it calculated the precise amount of disgorgement, sometimes to the cent. Further, we very much doubt the average retail investor has the information, records and capability to effect a reliable disgorgement calculation. **The Program Administrator should make the distribution at the time of notification without victims of the breach having to file a claim.**

Role of the Office of the Investor

We do not disagree with the recommendation that the Office of the Investor act as liaison between impacted investors and the Program Administrator, provided the necessary resources are made available. Exposure to the compensation process will give the Office a deeper appreciation of the challenges and emotions retail investors face when interacting with Dealers/ Representatives of the Dealers who have caused harm.

Accounting for Program administration costs

It is proposed that the cost of administering the Program will be extracted from the RF. We believe that these costs are more appropriately taken out of NewSRO's operating budget. By doing so, Member fees will increase, incentivizing Members to enhance supervision and compliance practices and more cash will be available for important investor protection initiatives from the RF.

We question the provision that the Program Administrator should have discretion to off-set "extraordinary" distribution costs from the disgorged funds. **We recommend that, in these hopefully rare cases, NewSRO should absorb the distribution costs as a fundamental duty as a modern Public interest self-regulator.** If this is not done, the value of the disgorgement Program to harmed investors would be devalued and NewSRO's public image could be diminished. If the cost of distributing disgorgement is so high that the effort cannot be cost justified, we do not disagree that it should not be pursued unless a particular case has a strategic investor protection value or message to NewSRO Member Firms and their representatives.

Compensation by third parties

In cases resolved by OBSI, it is not unreasonable to argue that the investor compensation made implicitly includes fees and commissions paid. Their loss calculation process is designed to make the complainant whole. However, such compensation does not include the amount of ill-gotten profits received / losses avoided by the Dealer / Dealer representative. We assume that in the vast majority of cases these components of disgorgement are not applicable, are relatively small, or are not calculated by NewSRO staff. If this assumption is correct, Kenmar would accept the argument that compensation received via the OBSI channel would make the investor ineligible for disgorgement awards .It should be noted that the odds are high that an OBSI compensation recommendation will be made well before a NewSRO hearing panel decision is announced.

We are unable to comment on investor disgorgement eligibility if IIROC arbitration is used due to our lack of knowledge on how ADR Chambers calculates the amount of compensation. We expect though, it also does not include ill-gotten profits received / losses received by the Dealer, as they are not a regulator.

We agree that investors receiving disgorgement cash should be required to agree that they will deduct the disgorgement dollars received from any future compensation received resulting from the misconduct. In the vast majority of cases we expect that

compensation decisions, like OBSI recommendations, will take place well before a NewSRO disgorgement decision is made.

Investor Education

Educational materials should explain the meaning and intent of disgorgement. The education materials should inform investors of their right to access disgorgement cash and how it may impact overall investor compensation. This education is necessary to avoid investor confusion. It is critical that the information about the disgorgement distribution Program clearly explain that acceptance of a payout from the disgorged funds distributed through the Program would not disqualify Eligible investors from seeking further compensation via other channels.

Issues related to disgorgement, complaint handling

We take this opportunity to again repeat our calls for NewSRO to release a modern complaint handling rule designed to provide fair compensation to harmed investors AND actions to eliminate the root causes of complaints. Enforcement, while necessary, is a post mortem activity, but robust complaint handling can lead to a more trusted financial services industry by **preventing** recurring problems and systemic issues.

We also take this opportunity to caution IIROC/ NewSRO not to introduce investor compensation schemes like arbitration, which can improperly divert complainants from independent, CSA approved OBSI.

As an aside, NewSRO should take steps to improve monetary sanction collections- low collection rates raise questions about the credibility of deterrence. **Re** *Credible Deterrence in Securities Regulation* https://www.iosco.org/news/pdf/IOSCONEWS383.pdf#:~:text=The%20IOSCO%20report%20includes%20real%20examples%20of%20effective,report%20identifies%20seven%20key%20elements%20for%20credible%20deterrence%3A NewSRO may want to improve collection efficacy by (a) informing Credentialing Bodies that required disgorgements (or fines) have not been paid which could result in a revocation of a credential and (b) notifying other regulators, such as insurance regulators , that required disgorgements (or fines) have not been paid which could result in the individual not being registered. Such notifications may incent sanctioned individuals to pay up.

Conclusion

The Working Group has provided sufficient information on which to judge the proposal(s). This initiative is a positive step forward towards improving retail investor protection. In a number of touchpoints, the recommendations act more in favour of the Dealer or its representative than fair distribution of ill-gotten gains returned to victimized investors. We have made recommendations to amend the Program to tilt the balance in favor of investors impacted by misconduct. Complainants do not deserve to be stressed a second time because of the Program design.

We do not understand why harmed investors need to file a claim and prove their losses. NewSRO has determined the total amount to be disgorged by reviewing the accounts of all the harmed investors and adding them up to determine the total amount to be disgorged. If investors are compelled to file claims and do the analytical work to justify their claim, we expect the fallout rate will be high, thus adversely impacting the regulatory intent of the Program. **We recommend that NewSRO (or the Dealer) do the spadework and then notify all impacted investors along with a cheque or e-transfer for the amount owing to them.**

Beyond disgorgement, we expect NewSRO to prioritize, where applicable, investor compensation in enforcement actions over the allocation of fines and other sanctions. We believe this modern practice is in the Public interest and will be most impactful in effecting credible deterrence and lead to enhanced Dealer supervisory / compliance systems and enhanced Rep training to prevent future infractions. Full compensation payment to investors could be considered a positive mitigating factor in settlement hearings while inadequate or no compensation should be considered an aggravating factor.

Permission is granted for public posting of this comment letter.

Please do not hesitate to contact us if there are any queries regarding our submission.

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