FAIR Canada Canada's Investor Rights Advocate | Promoteur des droits des investisseurs

April 28, 2023

General Counsel's Office
New Self-Regulatory Organization of Canada (New SRO)
GCOcomments@iiroc.ca

Re: Proposal on Distributing Funds Disgorged and Collected through New SRO Disciplinary Proceedings to Harmed Investors

FAIR Canada is pleased to provide comments in response to the above-referenced Consultation.

FAIR Canada is a national, independent, non-profit organization dedicated to being a catalyst for the advancement of the rights of investors and financial consumers in Canada. We advance our mission through outreach and education, public policy submissions to governments and regulators, and proactive identification of emerging issues. As part of our commitment to be a trusted, independent voice on issues that affect retail investors, we conduct research to hear directly from investors about their experiences and concerns. FAIR Canada has a reputation for independence, thoughtful public policy commentary, and repeatedly advancing the interests of retail investors and financial consumers.[1]

A. General Comments

Investor Compensation Promotes Public Confidence and Trust

FAIR Canada supports a program for returning funds disgorged through enforcement proceedings to investors who have suffered a loss (the Program). We also support the Program's structure, which involves distributing funds to investors following the enforcement process.

Compensating harmed investors helps promote public confidence and trust that the regulatory system is working for investors. It aligns with the New SRO's commitment to investor protection and building Canadians' trust in financial regulation and the people managing their investments. By compensating aggrieved investors, regulators can demonstrate their commitment to strong investor protection, which boosts Canada's position as an attractive investment venue.[2] Conversely, the inability to compensate wronged investors can erode confidence in the capital markets and the regulatory system.

[1] Visit www.faircanada.ca for more information.
[2] Ying Hu, The Role of Public Enforcement in Investor Compensation: A Hong Kong Perspective, Common Law World Review, Volume 46, Issue 3, 2017, p. 8.

Investors Expect Compensation

The Consultation expressed concerns about shifting the primary focus of the New SRO's enforcement process to investor compensation instead of prevention and deterrence of misconduct. We understand the importance of focusing on prevention and deterrence, but addressing investor compensation is also necessary.

As the New SRO's own research has shown, what wronged investors expect is a process for getting their money back. The research found that "… what most complainants were expecting is for a regulatory body to (1) provide counsel as to how much compensation would be reasonable to expect…, and (2) assist complainants by acting as a mediator or by negotiating on their behalf, to obtain compensation from the alleged [wrongdoer].[3]

As one legal scholar put it, "…while criminal and administrative sanctions punish wrongdoers and have some deterrent effect on other potential wrongdoers, they provide cold comfort to investors who have suffered financial loss. From an investor's perspective, compensation is more appealing than any fines that the [regulator] might impose…".[4]

The Program Will Help Meet Consumer Expectations

The Consultation suggested that introducing the Program may confuse investors because the dispute resolution and investor compensation landscape is already complex. We disagree. Rather, the Program supports investor expectations that when they suffer a loss, they should be compensated. We also believe the prospect of returning funds to injured investors through the Program (particularly if it is enhanced as we suggest below) outweighs concerns about creating investor confusion.

Various factors already restrict investors' ability to obtain compensation. These include litigation costs, limited resources for regulators to prosecute all cases involving loss, and assets that wrongdoers have hidden offshore. Given these realities, all possible avenues, including the Program, should be available to help harmed investors recover their losses.

B. Overview of Specific Comments

Below we discuss suggestions for enhancing investor compensation. These include:

- Improving the New SRO's collections process;
- Using fines to satisfy investor losses in certain situations;
- Prioritizing investor compensation in enforcement proceedings; and
- Supporting efforts to ensure New SRO members accept recommendations for compensation made by the Ombudsman for Banking Services and Investments (OBSI).

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[3] Navigator, Qualitative Research among Complainants – A Report to the Investment Industry Regulatory Organization of Canada, March 2021, at p. 12.
[4] Ying Hu, *supra* note 2, at p. 12.

Lastly, we comment on certain features of the Program proposed in the Consultation, including:

- Eligibility;
- The investor notification and application process;
- Program administration; and
- The claim amount and collections.

C. Enhancing Investor Compensation

Improve Collections

Under the Program, investors will only be notified and able to apply for compensation if and when monies have been collected from a wrongdoer. As such, the Program's success will largely depend on collection rates.

The data provided in the Consultation suggests that, unless collection rates are improved significantly, the Program may not deliver on investor expectations. Typically, only a fraction of the amount ordered disgorged is actually collected. Between 2009 and 2023, the New SRO ordered just under $8 million to be disgorged but collected less than $1.1 million. This represents a collection rate of just 13%.

These statistics underscore the need for the New SRO to improve its collection rate. It is also important to ensure funds are collected in a timely manner. Low collection rates or long delays collecting funds will undermine the Program's perceived utility and success.

Provincial and territorial legislative amendments that permit the New SRO to enforce its decisions as court orders should help improve collections. However, they may not be enough. We strongly recommend that the New SRO consider other ways to help improve collections.

The U.S. Securities and Exchange Commission's (SEC) approach is helpful in this regard. In 2002, the *Sarbanes-Oxley Act* created the "fair fund" provision, which allows the court or the SEC to order disgorged amounts and civil monetary penalties to be placed in a fair fund for distribution to investors who were harmed by the violation.[5]

In an SEC report shortly after the enactment of the statute, the SEC discussed the factors that were hindering collections, such as the fact that a small number of delinquent wrongdoers accounted for a disproportionate share of uncollected money.[6] It also highlighted the factors that were facilitating collections, such as asset freezes and the appointment of a receiver.[7]

[5] Sarbanes-Oxley Act of 2002, s. 308(a).
[6] SEC, Report Pursuant to Section 308(c) of the Sarbanes Oxley Act of 2002 at p. 7.
[7] Ibid. at p. 1.

The SEC has taken several steps to improve its collections program, including written guidelines for staff on how to pursue collections, a collections tracking system, and designated personnel to oversee the program.[8]

The SEC also uses a variety of methods to bolster collections, including sending demand letters, garnishing wages and negotiating a payment plan with the wrongdoer.[9] In 2020, the SEC created the Office of Bankruptcy, Collections, Distributions, and Receiverships in the Division of Enforcement "to further build upon improvements in distributing money to investors."[10] In fiscal year 2020, the SEC distributed over $600 million to harmed investors.[11]

We recommend that the New SRO conduct a review of its collections program and consider what other measures could enhance the timeliness and rate of collections.

The New SRO should also provide more transparency in its enforcement reports about its collections process. This will allow stakeholders to better understand the New SRO's challenges and progress in collecting monetary sanctions and could generate helpful discussions about how to improve collections.

We encourage the New SRO to develop innovative solutions to strengthen collections. This includes working with governments and regulators to ensure it has the necessary collection tools. For example, the British Columbia *Securities Act* was recently amended to provide the British Columbia Securities Commission (BCSC) with, among other things, enhanced collection powers. It now allows a person's driver's license and license plates to be withheld if they fail to pay amounts owing to the BCSC.[12] The Ontario Capital Markets Modernization Taskforce's report recommended similar measures for failure to pay amounts ordered by the Ontario Securities Commission (OSC) or the courts.[13]

Use Fines to Satisfy Investor Losses

The Program currently does not contemplate using monetary sanctions such as fines to satisfy investor losses. We encourage the New SRO to consider whether there would be appropriate circumstances where fines might also be used to provide compensation, particularly when there is a failure to collect on disgorgement orders.

Fines represent a substantial proportion of the sanctions imposed in New SRO enforcement proceedings. Between fiscal years 2018 and 2022, the New SRO ordered approximately $9.6 million in fines from firms, compared to only $116,000 in disgorgement from firms over the same period.[14] Similarly, with individuals, fine orders are significantly larger than

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[8] Ibid. at p. 28 – 29.
[9] SEC Investor Bulletin, How Victims of Securities Law Violations May Recover Money, June 21, 2018.
[10] SEC Division of Enforcement 2020 Annual Report, p. 5.
[11] Ibid.
[12] Securities Act, RSBC 1996, Chapter 418, s. 163.2.
[13] Capital Markets Modernization Taskforce Final Report, January 2021, recommendation 56 [Taskforce Final Report].
[14] New SRO Enforcement Report 2021 - 2022, p. 20 [Enforcement Report].

disgorgement orders. Between fiscal years 2018 and 2022, the New SRO ordered approximately $8.9 million in fines from individuals vs. $1.25 million in disgorgement.[15]

In cases where disgorgement and a fine are both ordered but only the fine is collected, the New SRO should consider using the fine to provide some compensation to investors.

We recommend that the fine relate to the same violation as the disgorgement – i.e., fines from one case would not be available to satisfy investor losses in another case. This would be consistent with the general design principles of the Program. The New SRO could develop guidance outlining when fines would be used to compensate aggrieved investors. This approach would help to supplement the small amounts available to investors through disgorgement and make the Program more effective.

We are mindful that the purpose of disgorgement is to deprive wrongdoers of the financial benefit of their misconduct, not to compensate investors for their losses.[16] We also recognize that the New SRO does not have the ability to order restitution, which aims to make victims whole by compensating them for all their losses. We are not suggesting that the Program cross the line into restitution by using fines to fully compensate investors. The guidance could underscore that the New SRO does not have this power and establish clear parameters for using fines as a source of investor compensation.

Prioritize Investor Compensation

We encourage the New SRO to prioritize investor compensation in its enforcement activities, which is a key focus for some other capital markets regulators.

The Financial Industry Regulatory Authority, for example, stated that its "highest priority when it identifies misconduct is to seek restitution for harmed investors."[17] Similarly, the SEC prioritizes investor compensation. In Hong Kong, the Securities and Futures Commission began changing its enforcement strategy over a decade ago to prioritize investor compensation. Instead of commencing criminal and disciplinary proceedings to deter market misconduct, it started bringing an increasing number of civil actions to obtain compensation for harmed investors.[18]

Given that most enforcement matters are resolved by settlement agreements, investor compensation should also be a key consideration when deciding to enter into such agreements.[19]

Support Efforts to Ensure Members Comply with OBSI Recommendations

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[15] Ibid.
[16] OSC, In the Matter of Maitland Capital Ltd., Reasons and Decision on Sanctions, November 4, 2011, at paragraphs 34 and 43 and In the Matter of Limelight Entertainment Inc., Reasons and Decision on Sanctions, December 10, 2008, at paragraph 48.
[17] Financial Industry Regulatory Authority, Report on Use of 2021 Fine Monies, June 24, 2022.
[18] Ying Hu, *supra* note 2, at p. 1.
[19] Enforcement Report, *supra* note 14, at p. 6.

Another way for the New SRO to support investor compensation is to promote and ensure other avenues available to investors are as effective as possible. This includes finding ways to encourage New SRO members to abide by OBSI recommendations following an impartial and independent review of complaints.

OBSI has a solid track record of compensating harmed investors. In 2022, 33% of investment complaints to OBSI ended with monetary compensation and OBSI awarded approximately $1.3 million in compensation.[20] This contrasts with the New SRO which, over an almost 14-year period (2009 to 2023), ordered just under $8 million to be disgorged, but collected a mere $1.1 million.

Despite OBSI's apparent success, however, low-ball settlement offers and outright refusals to follow OBSI's recommendations continue to harm consumers. The recent independent review of OBSI's investments mandate found that over a five-year period, investors received almost $3 million less in settlements from investment firms than what OBSI had recommended.[21]

If we are serious about compensating wronged investors, we need to ensure that all OBSI member firms abide by OBSI's recommendations. FAIR Canada calls on the New SRO to do everything it can to address the issue of low-ball settlements or outright refusals of OBSI's recommendations by its members. We also encourage the New SRO to support the proposal by the Canadian Securities Administrators (expected to be published this year) to create a binding mechanism for OBSI recommendations.

D. Comments on Certain Features of the Program

Eligibility

FAIR Canada agrees that to be eligible for payments from disgorged funds, an investor must have suffered a direct, provable, and quantifiable financial loss because of the misconduct, not directly or indirectly benefited from or engaged in the misconduct, and not received compensation for the same loss from other sources.

Limiting eligibility to those who suffered a direct financial loss because of the violation is reasonable. As noted above, disgorged amounts collected are typically low relative to investor losses. Expanding eligibility beyond those who experienced a direct loss would reduce the already small amount that each investor would receive. The requirements that the investor must have suffered a direct loss and not engaged in the misconduct are consistent with the eligibility criteria under the BCSC's regime for returning money to harmed investors.[22]

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[20] OBSI Annual Report 2022, p. 45. Similarly, in 2021, 38% of investment complaints to OBSI ended with monetary compensation and OBSI awarded approximately $1.9 million in compensation (OBSI Annual Report 2021, p. 44.)

[21] Poonam Puri and Dina Milivojevic, Independent Evaluation of the OBSI Investments Mandate, June 13, 2022, p. 36.

[22] BC Policy 15-603 Returning Funds to Investors, March 27, 2020.

Under the Program, investors can receive compensation whether or not they complained to the New SRO or provided witness testimony at the disciplinary hearing. FAIR Canada prefers this approach to the first model in the Consultation (i.e., distribution of funds to investors is built-in to the enforcement process), where eligibility is limited to those investors who participated in the enforcement proceedings.

In our view, it is neither necessary nor desirable to require investors to participate in enforcement proceedings to be eligible for compensation. These proceedings would likely be stressful, time-consuming and difficult for the average retail investor to navigate. Moreover, it would disadvantage those investors who may not have been asked to provide testimony or who were unable to do so, even though they suffered from the misconduct.

We support the proposed approach, which minimizes the burden on investors by not mandating their participation in the proceedings, and is fairer to those investors who suffered a direct loss but are unable to take part in the proceedings.

We agree that investors who receive a payment under the Program should be able to seek fuller compensation through other avenues. Given the low amounts that will be available for distribution under the Program, it is important to preserve investors' right to use other fora to enhance their chances of recovery.

We also agree that investors should not be entitled to double recovery. As such, we support the requirement for investors to disclose the amount received under the Program and agree that they should not be entitled to collect this amount in other proceedings. Similarly, to be eligible for a disbursement under the Program, an investor must not have received full compensation for the same loss elsewhere.

Investor Notice and Application

After the New SRO collects disgorged funds, the Program Administrator would provide notice to all known eligible investors that they can take part in the distribution. The notice would be sent to the potential claimants' last known addresses. We recommend sending two notices to increase the chances that they will see it and respond to it.

Regarding the timeframe for an investor to respond to the notice, we believe 30 days is too short and recommend that investors be given at least 90 days to apply to the Program. The amount of time an investor has to request a reconsideration of their entitlement amount should also be increased from 30 days to at least 90 days.

Under the BCSC regime, the application deadline must be at least three months from the date of the notice,[23] and there are two cases where the application timeline is considerably longer. In one instance, the application period is over 120 days and in the other, investors were given about three years to make a claim.[24]

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[23] Ibid.
[24] BCSC, Returning Funds to Investors - Money Received Under 161(1)(g) Orders.

To help ensure that investors understand the compensation process, the New SRO should create clear, plain language Program materials, including an application form and a guide. This is consistent with the approach of provincial securities regulators such as the BCSC and the Manitoba Securities Commission.

We also urge the New SRO to ensure that the notice, the key document that triggers the compensation process for the investor, is drafted in a way that boosts investor engagement. The New SRO should conduct behavioural research to determine how best to craft the Program materials to enhance investor participation.

Finally, Program materials should manage expectations about what the Program can achieve given that, in practice, investors may receive relatively small amounts of compensation relative to their losses.

Program Administration

We disagree that the New SRO's Office of the Investor (OI) should act as the liaison between the Program Administrator and investors. While we appreciate the OI's important role in investor outreach, we question the need for an intermediary. We recommend that the Administrator deal with investors directly to simplify Program administration and reduce costs. The OI could still support the Administrator, as needed.

We also disagree with the New SRO's restricted fund covering the Program's administrative costs, such as providing notice to investors and the administration and payment of claims. We believe the New SRO's operating budget is a more appropriate source for the Program's administrative costs. Drawing on the restricted fund to finance the Program would leave less money in the fund for important investor protection initiatives. Using the operating budget would show that the Program is a core operational feature of the New SRO and that the organization prioritizes investor compensation, consistent with our recommendation above.

We recommend that the New SRO's annual enforcement reports include information about how the Program is working, including challenges and successes. This aligns with our recommendation above for more transparency in enforcement reports about the collections process. Given the New SRO's public interest mandate and the Program's goal of returning money to harmed investors, it is important to be candid about the Program's effectiveness. A lack of transparency could undermine public confidence in the Program and the regulatory regime.

Claim Amount and Collection

We support the New SRO's decision not to limit the amount investors may claim through the Program. This approach will ensure that the Program helps compensate investors for their losses as much as possible.

We agree that the New SRO should collect disgorged amounts and distribute them to investors instead of paying them directly to investors. This proposal is consistent with the

BCSC's approach. The New SRO has more resources and knowledge of collections, making it better suited and able to collect disgorged amounts than individual investors.

Placing the onus of collections on everyday investors would be an additional hurdle as they try to get their money back. The Capital Markets Modernization Taskforce addressed this issue in its recommendation for a statutory process to distribute disgorged funds to investors. The Taskforce stated that "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."[25]

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Thank you for considering our comments on this important issue. We welcome any further opportunities to advance efforts that improve outcomes for investors. We intend to post our submission on the FAIR Canada website and have no concerns with the New SRO publishing it on its website. We would be pleased to discuss our submission with you. Please contact Jean-Paul Bureaud, Executive Director, at jp.bureaud@faircanada.ca or Tasmin Waley, Policy Counsel, at tasmin.waley@faircanada.ca.

Sincerely,

Jean-Paul Bureaud
Executive Director
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[25] Taskforce Final Report, *supra* note 13, recommendation 72.