July 30th, 2020

Reference: Canadian Securities Administrators (CSA) Consultation Paper 25-402

To whom it may concern at:

Alberta Securities Commission
Autorité des marchés financiers
British Columbia Securities Commission
Financial and Consumer Services Commission (New Brunswick)
Financial and Consumer Affairs Authority of Saskatchewan
Manitoba Securities Commission
Nova Scotia Securities Commission
Nunavut Securities Office
Office of the Superintendent of Securities, Newfoundland and Labrador
Office of the Superintendent of Securities, Northwest Territories
Office of the Yukon Superintendent of Securities
Ontario Securities Commission
Superintendent of Securities, Department of Justice and Public Safety, Prince Edward Island

I would like to submit my response to the Canadian Securities Administrators (CSA) Consultation Paper 25-402 - the review of the regulatory framework of self-regulatory organizations (SRO) that is comprised of the Investment Industry Regulatory Organization of Canada (IIROC) and the Mutual Fund Dealers Association of Canada (MFDA). The Consultation Paper is designed to elicit responses from industry representatives, investor advocates and the general public. It is this last category, the general public, that I represent- I have neither worked with any of the investment firms (I use this term broadly to refer to any organization involved with wealth management or money management) nor worked for a regulatory body.

My interest this matter stems from my observations of prevalent misconduct in the wealth management industry. This has resulted in significant financial losses to investors that was not prevented, or detected in a timely manner, by a number of parties charges with oversight of these entities. In my view no other industry is responsible for so much deliberate, or unintentional, losses incurred by the average member of the Canadian public.

I would like to preface my comments by acknowledging the complexity of the wealth management industry. From the inception of an investment to the release of capital are many participants, with varying objectives, overseen by a patchwork of different parties. Whenever the owner of an asset is distinct from the manager, or custodian, of such assets there will always be a conflict of interest between the manager in discharging their fiduciary duties and the owners who seek capital preservation and a return on their investment. For example, an asset-backed security that starts with the homebuyer who purchases a house requires a portion to be funded by debt. The debt is borrowed from a lender (e.g., a bank) who, in turn, pools or collateralizes similar loans in to a marketable security. The illiquid asset, the loan to the homebuyer, has now been transformed into a tradable asset with underlying features and risks based on maturity date, interest rate, inflation assumptions and default or delinquency rates. Such securities are purchased by the investment industry who in turn retains brokers to promote these products to institutional investors, such as hedge funds, and eventually the general public, referred to as retail investors. Overseeing the efficacy of this flow of services and information are credit agencies, regulatory bodies and auditors, both internal and external. By the time the product is available to the retail investor it is incomprehensible, for any party, to understand from inception to completion.

When there are problems and monies are lost it is inevitably the retail investor, the final link in the process, who suffers the greatest harm. The primary reason for these losses is that the system is not designed to protect the retail investors' interests. A broker who is paid above average commissions to promote a product will, on balance, be biased toward this incentive above the best interests of the investor. An investment firm will, on balance, invest in riskier products in order to advertise higher returns regardless of what they've committed to in the prospectus. Likewise the originating funder, the bank in my example above, generally has various incentives that reward employees, and the shareholder, for extracting short-term income from an illiquid, long term asset. All of these opportunities encourages behaviour that deviates from what has been promised or implied by the manager of the assets. The average retail investor is bewildered by the options in the marketplace and is not equipped to discern his or her best interests. The notion of *caveat emptor* is usually offered as justification for such losses. In other words the retail investor is at fault for not performing sufficient due diligence.

The regulator, broadly referring to all oversight bodies, is the most important component of the governance process. The investors' interests must be the regulator's only objective. If the investors' interests are not protected then, over time, all market participants will lose their credibility. Once this happens there will no longer be an investment industry. The sole purpose of the regulator has to be to protect the investor. Any other objective, such as reducing "duplicative" costs between SROs, is a distant objective. Furthermore, duplicative costs indicates that there are problems with the oversight of participants. This is as a result of, and not the cause of, regulatory inefficiencies. Costs will be borne by money managers if they can demonstrate to the investor that their best interests are maintained. I am not sure if it was by design or by accident but I found it curious that public confidence in the regulatory framework was the 6th of 7 questions contained in the Consultation Paper. All other matters mentioned in the Consultation Paper are of limited, or perhaps academic, interest to the regulator. The only adjunct to investor protection is to mitigate investor confusion when trying to resolve complaints.

I have provided below a small sample of damages inflicted upon the retail investor. Based on the number of cases within the last few years it appears that this system has been manipulated by unscrupulous individuals to quietly, or blatantly, obtain the most amount of money from an unsuspecting public. Minimal repercussions to the individuals involved exacerbates this behaviour with repeat offenders often plying their trade under a different guise.

To wit:

Fortress Real Developments Inc.

From 2008 to 2017 Fortress raised $920 million from 14,000 retail investors to become Canada's largest syndicated mortgage company. Fortress promised investors the opportunity to invest in syndicated mortgages that offered an 8% return. The loans were to be secured by a mortgage against the property in order to register a claim on the land. In fact Fortress was investing in developers in the early stages of financing (design and engineering costs) which contain significant risks given that zoning approval may not be in place. Traditional lenders avoid this asset class due to the risks involved. Fortress encouraged investors to use RRSP funds if they were not able to raise the minimum $30,000 requirement. Fortress pursued Chinese and Portuguese immigrants who were not familiar with the language or the nature of these products. Investors were encouraged to speak to certain lawyers who were employed by Fortress which is a conflict of interest. Furthermore Fortress offered a commission of 15% to brokers, investment advisors and insurance agents versus the typical range of 2% to 4%. Brokers were also invited to Leaf and Raptor games and introduced to retired athletes at private events. In some of the syndicated deals with the developers part of the investment was set aside to pay interest to the lenders rather than from the developer's cash reserves. In other words the lenders were being reimbursed with their own money. The RCMP is now involved and have raided the head office of Fortress. **The retail investor was not protected.**

As background, in 2005 the MFDA imposed a life-time trading ban on the founder of Fortress. In 2007 this individual encouraged his clients to invest in penny stocks of a BC-based company. By 2009 this scheme had unravelled and the promoter was fined $10 million by the BC Securities Commission. In 2011 the Ontario Securities Commission (OSC) reached a voluntary settlement with this individual and he disgorged $2.7 million, paid a fine of $250,000 and admitted no wrong-doing. He then went on to form Fortress. **The retail investor was not protected.**

Cannabis Sector in Canada

Approximately 80% of shareholders in the cannabis sector today are retail investors. These investors have lost millions of dollars while a number of Bay Street stock promoters, hedge fund managers and investment bankers earned hundreds of millions of dollars before exiting at the peak market value. Most institutional investors exited their positions at the time of the initial public offerings. For example, a number of hedge funds profited by "shorting" the stock, knowing that the shares would be discounted when issued to the market. The hedge funds purchased a large portion of the financing which in turn was sold to retail investors who essentially funded these gains. I understand that this practice is being investigated by the OSC. **The retail investor was not protected.**

Robinhood Markets, Inc. & WealthSimple

Although this example is from the US there are components that are relevant for Canada. Robinhood Markets, Inc. (Robinhood) offers no trading fees or account minimums for its investors. However Robinhood is coming under scrutiny for targeting young, unsophisticated investors. According to research firm Alphacution Research Conservatory, Robinhood trades riskier products at a faster pace than any other retail broker. For example, in the first three months of 2020 Robinhood customers traded 40 times as many shares as Charles Schwab Corporation (Charles Schwab) customers and bought and sold 88 times more risky option contracts. The average age of a Robinhood customer is 31 and half of its customers are first-time investors. Although Robinhood is not being paid by its customers it is receiving money from "payment for order flow". When a Robinhood customer commences a trade there are Wall Street firms purchasing and selling these shares. These firms determine the price that the customer receives/ pays. These firms are engaging in financial arbitrage; they set the price to the customer, earn money on the margin and pay Robinhood a commission. Apparently most (all?) investment managers are involved in this practice. However, using dollars per average customer account, Robinhood earned $18,995 from the trading firms while Charles Schwab earned $195. **The retail investor was not protected.**

Wealthsimple, a Canadian money manager, is proposing a crypto-trading platform that will not charge a commission on trades but will earn money on the spread by working with liquidity providers that buy and sell from their own book of business. This appears to be a conflict of interest and room for abuse - **how will this be fair to the retail investor?**

Pace Securities Corporation

Pace Securities Corporation (Pace Securities), a subsidiary of Pace Savings & Credit Union, has been charged with conflict of interest and selling unsuitable financial products to its clients. IIROC is seeking to discipline two former senior executives at Pace Securities. As of April 2020 the shares of Pace Securities have lost 92% of their value. Pace Financial Limited (Pace Financial) and Pace Securities share the same Chief Executive Officer (CEO). This CEO approved $2.4 million in management fees paid from Pace Financial to Pace Securities. Pace Securities in turn sold high risk investments to clients who had indicated a medium to low risk tolerance. Several of these clients are at or near retirement age, acknowledged that they were unsophisticated in financial matters and expressed concern that the investment advisors at Pace Securities did not explain the risks involved with these products. The CEO has commented that these investors must have revised their investment preferences. How is this fair to the retail investor? Incidentally, Pace Credit Union (Pace Credit) with 39,000 employees was under the control of the Financial Services Regulatory Authority (FSRA) of Ontario. In September of 2018 the Deposit Insurance Company of Ontario seized control of Pace Credit due to a fraud being committed by the President and his son. The FSRA then launched an investigation of its own staff to see if they ignored warning signs since the fraud was so prevalent. **The retail investor was not protected.**

Stableview Asset Management

Stableview Asset Management (Stableview) managed $30 million on behalf of 135 clients with the primary objective of "capital preservation". The OSC found that Stableview invested in a thinly traded real estate valuation technology company which put Stableview in breach of its commitments to diversify its investment portfolio - it went from 45% to 83% concentration - and maintain liquid investments. Additionally Stableview was paid $105,000 from this company which was withdrawn by the owner of Stableview for his own use. This was not disclosed to the investors which is a conflict of interest. Stableview is now in receivership and it is unlikely that the investors will receive their principal. **The retail investor was not protected.**

Paramount Equity Financial (Paramount)

From 2014 to 2016, 500 investors contributed $78 million to two funds that were supposed to be financing pooled mortgage products. The marketing material of Paramount promised that investor funds would be invested in securitizing mortgages for second mortgages on single-family homes. In fact the funds were invested in land to be developed for multi-residential apartment buildings. These developments have subsequently failed. Investors were promised that the loan-to-value ratio would not exceed 85%; however of six deals reviewed four deals uncovered a ratio of over 150% and two deals could not be reviewed since there was no appraisal of the properties. Furthermore the CEO of Paramount also had ownership interest in many of the development companies which is a conflict of interest. An expert witness has highlighted an absence of policy, documentation and credit risk processes. The OSC is pursuing this matter. **The retail investor was not protected.**

Investment Advisor

A retired Ontario Provincial Police (OPP) officer is currently being investigated by the OSC and the OPP. He has been accused of implementing a “Ponzi scheme” and has several current and retired OPP officers as clients. He was promising returns of 21 to 26% on his investments. **The retail investor was not protected.**

FS Group

FS Group has been ordered by the BC regulators to pay fines of $37 million for harming over 400 investors. Its founders have been banned from the BC investment markets forever. Investors were not told that FS Group was unprofitable and that short-falls were being covered by raising more money from investors. No prospectus was filed by this organization. Investors were promised returns of 10 to 12%. FG Groups’s 100 agents were supposed to be selling insurance and not investing in unsecured loans. The regulator has stated that it is unlikely that FS Group can repay its investors. **The retail investor was not protected.**

TD Waterhouse

The IRROC has fined TD Waterhouse $4 million because of disclosure errors in 175,000 client accounts. There were problems with the book costs of investments used to reflect the purchase price and transaction charges. IIROC claimed “systemic weaknesses in TD Waterhouse processes” and did not accept their explanation that they forgot. **The retail investor was not protected.**

Fortune Financial Management

In the mid 1990's Fortune Financial Management was one of Canada's largest financial planning companies with over 550 employees and $7 billion in assets under management. A Chief Financial Officer for one of the funds accused the company as operating as a Ponzi scheme and approached the OSC with his concerns. The CEO is being pursued by the OSC who in turn took this case to the Ontario Court of Justice. **The retail investor was not protected.**

The Quadriga Fund

The OSC has recently announced that The Quadriga Fund (Quadriga), formerly Canada's largest cryptocurrency/ bitcoin exchange trader, was a "Ponzi scheme". EY concluded, as a part of their review, that standard segregation of duties and internal controls did not exist at Quadriga. 76,000 customers, 40% of whom reside in Ontario, are owed over $215 million. EY has recovered $46 million leading to a $169 million shortfall. $115 million of this shortfall arose from fraudulent trading and another $28 million was lost by the principal while trading client money on other exchanges. And investors do not have access to federal deposit insurance since this coverage does not extend to crypto currencies. Once again the retail investor is suffering losses. **The retail investor was not protected.**

EY

EY reached an $8 million settlement with the OSC, while admitting no wrongdoing, regarding the Sino Forest audit. The OSC concluded that EY did not demonstrate professional scepticism by not questioning the ownership of standing timber reserves in China. Additionally EY had to settle for $117 million in class action lawsuits filed by investors who relied on the audited financial statements. **The retail investor was not protected.**

BDO Canada

In January 2020 BDO Canada settled with the OSC for $4 million for failing to comply with professional standards with respect to audits in 2014 and 2015 of two privately offered investment funds. The "directing mind" behind the funds admitted to fraud in 2018. BDO was deemed to be non-compliant with generally accepted auditing standards when valuing the 2 funds. **The retail investor was not protected.**

Westboro Mortgage Investment LP (Westboro)

Alternative mortgage lender Westboro has suspended redemptions to investors in May 2020. Westboro blossomed since 2008 as rising prices for real estate and stricter underwriting practices by the banks led to alternative providers who offered a higher rate of return albeit with higher risks. Unlike all of the above examples there is no suggestion of fraud or incompetence; however a number of investors were surprised at this announcement. **Has the risks of these types of investments been explained to the retail investor? How far does *caveat emptor* apply in the marketplace?**

Responses to the Consultation Paper

The examples above demonstrate issues with wealth managers, regulators and the auditors overseeing their financial statements and internal controls. This is not meant to be an exercise in demonizing the regulatory agencies - there are many examples where the OSC or the SRO's are pursuing the culprits. However, almost without exception, it is the retail investor who suffers the most harm. The efforts of the oversight bodies and penalties meted out, either civil or criminal, are not sufficient deterrents to bad or irresponsible behaviour.

There is no point in highlighting the foibles of the existing process without offering a solution. It is too much to expect that the custodian of funds will always act in the best interest of the providers of capital. It is too tempting, and too slippery a slope, to divert these funds for personal gain or to obviate previous losses. Because there are so many steps in the investment process, involving different oversight bodies, the current regime does not lend itself to a "cradle to grave" protection of the investor. The only solution is to monitor the wealth management parties by proactively tracking the commitments of the money manager to their investment strategy. I have provided my suggestion below and answered the seven questions contained in the Consultation Paper.

There are three general areas of concern that has been identified in the analysis above of offending parties. The biggest concern is that the wealth manager is not investing the funds appropriately. For example if the prospectus commits that investors funds will be invested in residential mortgages then the regulator has to be provided with independent/ third party evidence, at the time the funds are discharged, that this is the case. And the investment would have to be monitored to ensure that the funds were not diverted for another purpose; similar to an insurance company notifying interested parties if the insured cancels their insurance. By obtaining this confirmation early in the process the regulatory process has evolved from reacting to problems to monitoring the activities of market participants. Over the longer term the costs to the investor will be smaller than the losses incurred by losing their capital. There are many other aspects to consider when designing this process; the overriding mantra is compliance with the terms and conditions of what has been promised to the investor. This model would encompass all material assertions of the money manager. The compliance program would identify unusual key performance indicators (KPI) assertions. A second concern that I have is money managers promising outsized returns on their investment. For example, if the money manager is promoting investment returns above what would be reasonable for similar underlying investments then further explanations would have to be provided to justify these returns. And the third general concern I have is conflict of interest. This is the most difficult process to monitor. However, more can be done with this issue. For example, evidence of ownership of assets would indicate if the same party was privy to unusual transactions, either grossly above or below market rates, that would be flagged for follow-up by the regulatory body. This topic requires further analysis before a suitable model could be designed.

1.1 Duplicative Operating Costs for Dual Platform Dealers

This compliance program should be designed to measure all KPI. This may have to be as specific as product based regulation, particularly if a product deviates from the standard offerings. There will be on-going costs to monitor the indicators for evidence of non-compliance. This is a change in approach but not an onerous task. And it is most effective if managed by less, rather than more, parties. I advise that one regulatory body assumes responsibility for the complete process. And within this body the process should be confined to as few individuals as possible in order that Parkinson’s Law - which states that people are hired to create more work, rather than as a result of more work - can be avoided. Similar requirements from different SRO’s will be avoided and the costs for compliance to the wealth manager will be transparent. The solution focuses on investor protection while allowing the SRO’s to provide the other services contained in their remit.

2.1 Product-Based Regulation

Another advantage of the above approach is that it aligns the various stakeholders with a common objective- to protect the investor. One body assigned responsibility for monitoring this program will result in less investor confusion when trying to resolve complaints.

3.1 Regulatory Inefficiencies

I have addressed this point in my responses to questions 4.1 and 5.1 below.

4.1 Structural Inflexibility

I have two points to offer. Firstly, one would hope that a regulator would be slow to respond to new products in order that they can perform sufficient due diligence. Advances in technology are not always beneficial to the investor- see my example of Robinhood above. Secondly, a new product that meets the requirements of appropriate monitoring, as I have outlined in my solution, should assuage concerns from the wealth managers that there are undue delays in issuing products to market. I agree that there are too many agencies involved in the process and I would like to see one administer of all of the steps involved - from creation to funding to investing in the products.

5.1 Investor Confusion

There is no question that this is a significant issue and follows closely my chief concern that investors are not being protected. There are so many categories and titles combined with regulatory overlap that it must be overwhelming for the average retail investor to resolve a complaint. And if the investor has lost all or a part of their investment then no resolution process will be satisfactory. My solution is to advocate for the interests of the investor and this should hopefully reduce both the severity of the financial harm and the volume of complaints.

6.1 Public Confidence in the Regulatory Framework

This is, as I have said in my introduction, the main issue. I have nothing further to say other than to warn that the public's patience with this industry surely will reach a breaking point unless demonstrable improvements to investor protection are implemented.

7.1 Separation of Market Surveillance from Statutory Regulations

I have already provided a solution in my response. Statutory regulation is the design of the program that has as its objective administering compliance with the prospectus or other promotional material: market surveillance monitors ongoing compliance with the performance of the money manager. And to be clear performance is not financial performance but compliance with the objectives of what the investor has been promised. I believe both roles should be under the auspices of one regulatory body, one department and ideally one individual.

I hope my thoughts, on how to design an effective regulatory framework for the wealth management industry in Canada in order to protect the average retail investor, are helpful.

Philip Maguire, C.P.A., C.A.