



**AUTORITÉ
DES MARCHÉS
FINANCIERS**

Fonds d'indemnisation des services financiers

Presentation of consultation findings
and proposed orientations

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Autorité des marchés financiers

This report presents the findings of the consultation on compensation of consumers of financial products and services and the orientations adopted by the *Autorité des marchés financiers*, but does not include the more detailed analysis that served as the basis for the November 2011 consultation: *Reference Guide – Protection Mechanisms*.

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In this report, where the context permits, the masculine gender includes men and women.

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INTRODUCTION

In recent years, public debate regarding compensation of victims of financial fraud has brought to light various viewpoints, both with respect to the objectives sought by the *Fonds d'indemnisation des services financiers* (the "Compensation Fund" or the "Fund") and with respect to the way in which it should operate. These viewpoints are centred on two major approaches:

- Some consider the scope of coverage offered by the Compensation Fund to be unsatisfactory or overly complex. They argue the need to fix the way it operates;
- Others, however, consider that the existing Compensation Fund is already very generous compared with compensation mechanisms in other jurisdictions. They are of the opinion that the Fund itself and any future improvements to the Fund would have an impact on the industry's competitiveness and the availability of financial products and services in Québec.

These positions reflect distinct, even opposing, visions of the objectives and role of compensation.

Within this context, the Minister of Finance of Québec and the Minister for Finance in the previous provincial government asked the *Autorité des marchés financiers* ("AMF") to hold a consultation on the compensation of victims of financial crime.

The purpose of the consultation was to allow the AMF to hear the various points of view of the public and industry members regarding the principles that should guide the compensation of victims of financial crime, before it gave its opinion on the effectiveness of existing compensation mechanisms or the need to improve them.

THE CONSULTATION

The consultation on compensation of consumers of financial products and services took place from December 9, 2011 to March 9, 2012. A Notice and Request for Comment¹ as well as a Reference Guide² were made available to interested parties in order to help them prepare their comments and interventions.

The AMF sought to hear the points of view of the public and industry members on the following seven issues:

ISSUE 1

Role of compensation among measures intended to protect consumers of financial products and services

ISSUE 2

Accountability of consumers and market intermediaries³

ISSUE 3

Fundamental objective of a compensation system

ISSUE 4

Approach with respect to consumer compensation

ISSUE 5

Responsibility for managing mechanisms intended to compensate victims of financial fraud

ISSUE 6

Products, intermediaries and conduct covered by the Compensation Fund

ISSUE 7

Funding the Compensation Fund and cost containment measures

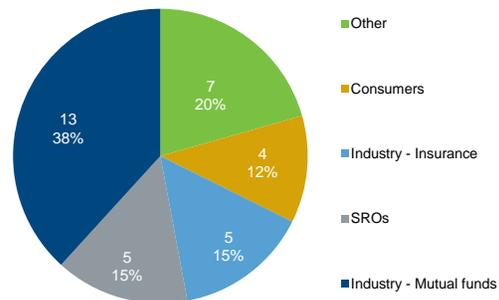
The AMF invited the public and industry members to respond to the questions formulated for each issue in order to identify major trends and arrive at a consensus on certain principles and orientations.

At the end of the consultation period, the AMF had received a total of 34 briefs⁴ from a broad range of stakeholders.

Of these, 13 came from within the mutual fund industry, five from within the insurance industry, five from self-regulatory organizations (“SROs”) and four from consumers or consumer associations. The remaining seven briefs were submitted by other stakeholders, including law firms, academics or professional orders, and were placed in the category “other.”⁵

CHART 1

Breakdown of respondents by group (number and percentage)



¹ Notice and Request for Comment regarding compensation of consumers of financial products and services, <http://www.lautorite.gc.ca/files/pdf/consultations/inde mnisation/avis-consultation-inde mnisation-an.pdf>

² Reference Guide – Protection Mechanisms, http://www.lautorite.gc.ca/files/pdf/consultations/inde mnisation/AMF-guide-ref_mecanisme-protection-an.pdf.

³ The expressions “market intermediaries” and “intermediaries” are used to simplify the text and mean both individuals and firms authorized to carry out activities covered by *An Act respecting the distribution of financial products and services* or the *Securities Act*.

⁴ It should be noted that, for statistical purposes, only 31 briefs were used. Those not considered were either service proposals or letters of support. They did not answer the questions asked.

⁵ Appendix 2 contains a list of all respondents.

CONSULTATION FINDINGS AND PROPOSED ORIENTATIONS

1. ROLE OF COMPENSATION AMONG MEASURES INTENDED TO PROTECT CONSUMERS OF FINANCIAL PRODUCTS AND SERVICES (ISSUE 1)

1.1 Background

In Québec, as elsewhere in developed countries, the financial industry is overseen rigorously.

The oversight framework established by the regulators relies on a set of measures:

- Marketplace rules;
- Solvency requirements;
- Transparency requirements;
- Requirements regarding competence and honesty and the obligation to carry liability insurance, particularly for market intermediaries;
- Inspection and investigation mechanisms;
- Complaint management mechanisms;
- Financial education programs;
- Recourses for consumers of financial products and services (“consumers”).

In particular, this oversight is intended to protect consumers by ensuring that the financial transactions in which they are involved take place in a reliable environment that inspires trust and is conducive to making informed decisions.

A number of arguments support rigorous oversight:

- The importance of financial transactions in the lives of consumers;
- The complexity of certain insurance and investment products;
- The large sums involved;
- The significant purpose of the transactions: taking out life insurance to ensure financial stability for survivors, taking out insurance to protect property against fire, theft or accidents, saving to finance retirement, building wealth, etc.

Regardless of the quality of the regulatory framework, recent experience has shown that no financial regulator can fully shield consumers against fraud.

Drawing inspiration from the systems set up by professional orders, Québec therefore established a mechanism to compensate victims of fraud.

Compensation is a mechanism intended to reduce the consequences of fraud. Its main purpose is to protect consumers against the consequences of conduct not covered by a liability insurance program. Compensation is therefore the last defence within a scheme to protect consumers.

The first issue consists in finding a fair balance between fraud prevention measures and victim compensation measures, keeping in mind that bolstering existing fraud prevention measures or modifying the compensation plan will necessarily have an impact on consumers, intermediaries and the industry as a whole.

1.2 Answers to questions asked

QUESTION 1.

Based on your perception of the Québec system, should we rethink the balance between fraud prevention and victim compensation measures?

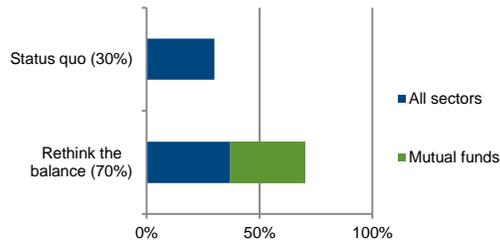
The purpose of this first question was to determine how the public and industry members perceive Québec’s compensation system. It also sought to elicit answers regarding the appropriate balance between prevention and compensation.

Of the 31 briefs selected for analysis, 24 specifically answered the question. Of those, 17 (70%) (eight of them from the mutual fund industry) were of the opinion that it would be advisable to **rethink the balance** between prevention and compensation measures. The other seven respondents (30%) were in favour of maintaining the **status quo**,

considering the current balance to be adequate.

CHART 2

Breakdown of respondents: Need to rethink the balance between prevention and compensation (percentage)



QUESTION 2.

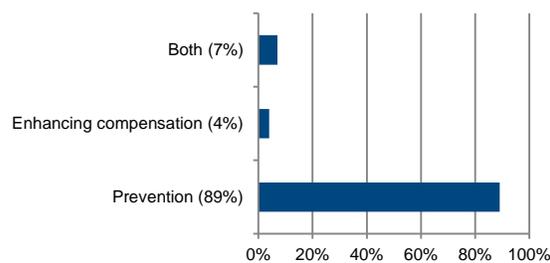
Since financial resources are limited, which solution should be given priority: bolstering fraud prevention measures or enhancing the compensation plan?

This question, which was directly related to the first one, sought to determine which approach should be given priority, if at all.

Of the briefs analyzed, 28 specifically answered the question. Of these, 25 respondents (89%) supported **bolstering prevention measures**, only one (4%) supported **enhancing the compensation plan**, while two (7%) were of the opinion that **both solutions should be adopted**, considering them to be of equal importance.

CHART 3

Breakdown of respondents: Approach to be given priority (percentage)



Among the 25 respondents **in favour of bolstering prevention measures**, a majority agreed that consumer education and the availability of relevant information were the best means for preventing fraud. In fact, the AMF received several proposals to that effect, the principal ones being as follows:

- Increase financial literacy;
- Create a national registry of sanctions imposed on individuals and firms;
- Assess and rate financial products (fiduciary rating);
- Publish a “pre-transaction” checklist for consumers to foster awareness about matters they should verify before entering into a financial transaction.

It should be noted that with respect to consumer education, several respondents lauded the AMF’s initiatives and the quality of its recent educational campaigns.

Certain respondents felt that bolstering prevention requires greater oversight of representatives and other market participants. In this regard, they made the following suggestions:

- Increase fraud-detection measures, namely, inspections and investigations;
- Tailor inspections to the risks that the firms being inspected represent;
- Increase the severity of sanctions;
- Improve complaint examination and mediation mechanisms.

Finally, a majority of respondents were of the opinion that the existence of the Compensation Fund is essential for maintaining consumer confidence.

1.3 Conclusion

Compensation is not a means for preventing fraud. It is a remedial measure used to minimize the effects of fraudulent conduct that oversight and control measures, no matter how efficient, can never completely eradicate.

Prevention is the best approach for protecting against fraud, and the consultation’s findings

confirm that all respondents, regardless of which group they belong to, share this vision.

Prevention may take several forms.

One respondent proposed instituting a **system for assessing and rating financial products**.

However, this approach presents significant challenges, including conflicts of interest the rating organization could face, the impact of possible errors in the rating of products, and the advisory role of intermediaries within such a system.

The results of the present consultation and the nature of the elements it raised do not support such a change of approach.

Moreover, this proposal runs counter to Québec legislation: While the legislation sets out rules with respect to financial products, it does not dictate their content⁶ any more than it requires that they be approved by the regulator. In other words, insofar as a product is legal, it is not the responsibility of the AMF or any other entity recognized by it to give the product a reliability or performance rating. The duty to advise with respect to product reliability and performance belongs to the various intermediaries whose ability is attested to by the AMF through their registration or certification.

Other respondents suggested that fraud prevention should involve **increased inspections and investigations**. In this regard, over the past few years, the AMF has significantly boosted its efforts to combat financial crime. It tripled the size of the teams dedicated to this task (inspections, investigations, legal department). Moreover, it set up new units specialized in market surveillance and cybersurveillance in order to better understand and thwart financial crime schemes.

Lastly, some respondents mentioned that fraud prevention should involve **more severe**

sanctions. In that regard, it is worth noting that in 2009, *An Act respecting the distribution of financial products and services*, the *Securities Act* and the *Derivatives Act* were amended in order to include tougher sanctions for violations.

In particular, *An Act respecting the distribution of financial products and services* was amended in order:

- to give the *Bureau de décision et de révision* the power to impose a penalty of up to \$2,000,000 on contravening firms;
- to confer upon the discipline committees of the *Chambre de l'assurance de dommages* and the *Chambre de la sécurité financière* the power to impose fines of not less than \$2,000 nor more than \$50,000 on representatives for each offence;
- to increase the maximum administrative penalties.

Given that these legislative changes are relatively recent, the AMF is of the opinion that it would not be appropriate to increase the sanction amounts at this time.

However, there are measures that can be implemented in order to make positive changes to existing consumer protection and assistance mechanisms.

Therefore, in accordance with its Strategic Plan, the AMF makes the following recommendations:⁷

- **continue its consumer education efforts** so that consumers have a better understanding of their personal finances, become more vigilant and, ultimately, protect themselves against financial crimes. The AMF believes that well-informed consumers who ask the right questions and understand what they are being offered on financial markets are better able to manage their finances and detect and avoid fraud;

⁶ There is an exception to this rule. In the field of automobile insurance, the regulator dictates the content of contracts by imposing the use of forms which it approves under section 422 of *An Act respecting insurance* (R.S.Q., c. A-32).

⁷ The Strategic Plan is available at: http://www.lautorite.qc.ca/files/pdf/publications/autorite/plan-strategique_2012-2017_ang.pdf.

- **continue to foster a “customer-centric approach” among its consumer assistance teams when dealing with consumers who are victims of fraud.** In addition to the ability to access the Compensation Fund, this approach will provide better support to consumers seeking the AMF's assistance.

The AMF also recommends as follows:

- **disseminate information to consumers about the various services the AMF offers them:** information, complaint examination, whistleblowing and compensation;
- **develop fraud indicators, based on claims filed with the Fund, so as to support the AMF's education, fraud prevention and inspection efforts.**

2. ACCOUNTABILITY OF CONSUMERS AND MARKET INTERMEDIARIES (ISSUE 2)

2.1 Background

The fight against financial fraud is a responsibility shared by regulators, market intermediaries, financial institutions and consumers.

Regulators must establish and administer an effective framework for governing the financial industry so that fraud is prevented.

In particular, market intermediaries must act with honesty, loyalty and competence, in the best interests of their clients.

Financial institutions must implement risk management practices within an efficient governance framework in order to detect, prevent and remedy activities associated with financial crime, including fraud.⁸

For their part, consumers must act with prudence when carrying out transactions.

In practice, the presence of a compensation plan can affect consumer behaviour. The extent of coverage and the percentage of losses reimbursed may affect the amount of risk taken by consumers (referred to as “moral hazard”).

The corollary to lack of consumer accountability is lack of accountability among market intermediaries.

Moral hazard risk results from the fact that the intermediary, unlike his client, is not directly exposed to the financial consequences of his conduct. The parameters of the compensation system may also influence intermediary accountability if these parameters are such that the intermediary knows the client will be compensated regardless of the circumstances.

The second issue therefore consists in determining how the compensation mechanisms in Québec can ensure that both consumers and intermediaries remain accountable.

⁸ *Autorité des marchés financiers*, Financial Crime Risk Management Guideline, June 2012.

2.2 Answers to questions asked

QUESTION 3.

Do consumers have a certain responsibility to avoid financial fraud?

The AMF received 26 answers to this question. It is interesting to note that all respondents, regardless of the group they belong to, felt that **consumers have a share of the responsibility** for finding the means to avoid fraud.

A number of them felt that it was important to encourage consumers to develop a systematic **verification reflex** (registration of intermediaries and financial institutions, reasonableness of products offered, etc.).

Others were of the opinion that this **accountability is proportional to the information available to consumers**, referring, in particular, to the quality of public records and the information they contain. A few respondents stated that the accountability of consumers goes hand in hand with consumer education.

Finally, two respondents raised the idea of adopting a **charter of consumer rights and responsibilities** in order to clearly establish the role of consumers in preventing financial fraud.

QUESTION 4.

How much importance should the compensation mechanisms in Québec place on the accountability of consumers and intermediaries?

Of the briefs selected for analysis, 27 specifically answered the question.

Of these 27 respondents, 18 (67%) were of the opinion that consumers and intermediaries **share accountability** in cases of financial fraud. According to them, compensation mechanisms in Québec must place importance on the accountability of both consumers and intermediaries.

Respondents in favour of shared accountability did not however offer concrete

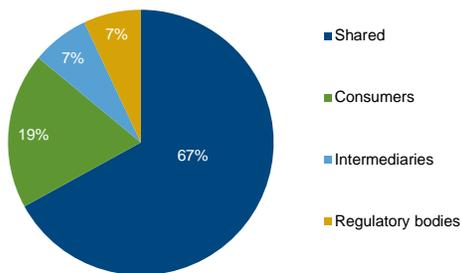
proposals for how to articulate the shared responsibilities, although they did suggest that consumers must carry out basic verifications before purchasing a financial product. Here too, consumer education was advocated.

Five respondents (19%) were of the opinion that compensation mechanisms must focus on the **accountability of consumers**, while two respondents (7%) were in favour of emphasizing the **accountability of intermediaries**.

Respondents who advocated for consumer accountability thought that the potential indemnity should be reduced based on a consumer's degree of responsibility for the fraud. In other words, they proposed that the compensation system **take into account the negligence of a consumer in managing his affairs** and apportion a share of the responsibility for the losses suffered as a result of a fraud based on the principle of the contributory fault of the victim.

Lastly, two respondents (7%) suggested that compensation mechanisms should place a certain degree of emphasis on the **accountability of regulators**. However, they did not indicate what form this accountability should take.

CHART 4
Breakdown of respondents: Responsibility of parties (percentage)



QUESTION 5.
Should a consumer who knowingly makes an illegal investment lose the right to be compensated in the event of fraud?

The 23 stakeholders who responded were almost unanimous in answering this question in the affirmative. Only one held a contrary opinion.

Those who answered in the affirmative felt that the Compensation Fund should not be used to improve, or protect against, a transaction a consumer knows to be unlawful. From their point of view, the Compensation Fund was established in order to protect consumers who become victims due to situations over which they have no control: fraud committed by the intermediary with whom they are dealing.

For them, accessibility to the Compensation Fund is a privilege and not a right: A contrary position could allow consumers to profit from participating in illegal transactions.

The respondent who answered in the negative felt that it would not be advisable to take this approach due to the difficulties that would arise in proving a consumer's knowledge of the illegal nature of a transaction. This position is based on procedural considerations.

2.3 Conclusion

All parties involved in a financial transaction share some responsibility for the transaction. Intermediaries must act in compliance with the rules applicable to their industry segment. As for consumers, they must act with reasonable care.

The consultation led to the following findings:

- 100% of respondents considered that consumers have a certain responsibility for preventing fraud;
- 67% of respondents considered that compensation mechanisms should place importance on the accountability of both representatives and consumers;
- 95% of respondents were of the opinion that a victim who knowingly violates tax or other legislation when carrying out a transaction should lose the right to be compensated.

Certain respondents suggested that the system should assist consumers by providing them with all the relevant information they

need in order to carry out basic verifications before entering into a transaction. They felt it would be appropriate to **enhance the existing register** of firms and individuals authorized to practise, by including information such as training activities attended by intermediaries and any disciplinary or other sanctions imposed on them. Some even suggested the creation of a **national register** of individuals and firms.

At present, the AMF's register is quite straightforward. Consumers are asked to enter the name of the individual or firm with which they want to do business. The search yields two possible results: (1) the name of the individual or firm appears in the register and the consumer thereby knows that the individual or firm has the requisite right to practise or (2) the name of the individual or firm does not appear in the register and the consumer can thereby infer that the individual or firm does not have the requisite right to legally pursue activities.

The AMF checks the integrity of the intermediaries to whom it issues a right to practise.

The AMF is of the opinion that consumers should not have the burden of validating the integrity of intermediaries with whom they wish to do business. If a consumer ensures that the name of the intermediary appears on the AMF's register, this should be synonymous with integrity.

Moreover, there is not necessarily a cause and effect relationship between fraud and a history of sanctions. In other words, an intermediary who has received disciplinary or administrative sanctions is not necessarily a defrauder. Conversely, the absence of sanctions in an intermediary's file is not a guarantee of anything.

Consequently, the AMF is not currently considering enhancing its register.

However, if the Government were to create a register of all sanctions related to the financial sector, the AMF would willingly contribute to it.

Similarly, the AMF would consider modifying its register if a Canada-wide review of the

matter were to show that such a modification is desirable. Appropriate adjustments for purposes of harmonization could then be contemplated.

The consultation also revealed a surprising fact: 19% of respondents were of the opinion that the compensation system should **emphasize the responsibility of consumers** over that of intermediaries.

This position is contrary to the one adopted by the courts in Québec and the Supreme Court of Canada.⁹ In fact, the courts have tended to find that intermediaries have a greater share of the responsibility for financial transactions than consumers do, because they are the specialists and they have more in-depth knowledge of the markets.

According to the courts, the scope of an intermediary's duty to advise is inversely proportional to the client's level of knowledge: The less the client knows about investments, the more the intermediary will be accountable. The client-intermediary relationship is based on trust. The courts take into account the very real fact that a client who has a great deal of confidence in his intermediary may be less vigilant.

The financial products and services industry is increasingly complex. Over the past few years, there has been a proliferation of new products, each with more elaborate features than the next. As a result, laypersons may find it difficult to understand these products and this is precisely why consumers entrust their affairs to intermediaries. Consequently, we cannot require consumers to be experts in the financial sector before entering into a financial transaction for which they have

⁹ See for example: *Souscripteurs du Lloyd's v. Alimentation Denis & Mario Guillemette inc.*, 2012 QCCA 1376, leave to appeal rejected by the Supreme Court on April 4, 2013 (file 35011); *Laflamme v. Prudential-Bache Commodities Canada Ltd.*, [2000] 1 S.C.R. 638; Raymonde Crête, "Les manifestations du particularisme juridique des rapports de confiance dans les services de placement", in *Courtiers et conseillers financiers: Encadrement des services de placement*, under the dir. of Raymonde Crête, Mario Naccarato, Marc Lacoursière and Geneviève Brisson, Coll. Cédé, Cowansville, Les Éditions Yvon Blais inc., 2011, 275, p. 321-322.

sought the services of a professional in whom they have full confidence.

However, a review of recent financial frauds committed in Québec suggests that in a few cases consumers made investments knowing or having good reason to believe that Québec laws, in particular tax laws, were not being respected. For example, some of them agreed to invest based on a promise that the investments would be made in foreign tax shelters.

While consumers may not always have a sufficient understanding of the terms and conditions of proposed products, such conduct clearly cannot be encouraged. Full compensation without administrative monitoring of the losses is therefore not advisable.

In addition, a review of the claims filed with the Compensation Fund indicates that fraudsters often require payments in cash. Here too, certain mechanisms could be considered in order to curb this practice.

Finally, an analysis of claims filed with the Compensation Fund over the past few years shows that certain intermediaries (firms or other entities that are not individuals) sometimes carry on other professional activities. This can be confusing for consumers.

For example, the AMF had to consider the case of a firm that was registered with the AMF in insurance of persons and group insurance of persons but also carrying on other activities (in this case, real estate investments). These services were being

offered to consumers through a representative of the firm.

At present, by contrast with the rules that apply to representatives, *An Act respecting the distribution of financial products and services* and the regulations adopted under the Act do not impose any restrictions on the activities of firms. Yet, these activities, which do not form part of the insurance business and are not incompatible with existing rules, can have a negative impact on an intermediary's ability to hold a right to practise.

Therefore, in light of the foregoing, the AMF recommends:

- regulatory amendments to establish a mechanism, like the one that exists within the professional orders governed by the *Professional Code* (R.S.Q., c. C-26), whereby a victim of fraud could see his claim for compensation rejected in the event of, in particular, false declaration, willing participation in the fraud, investments made to avoid tax, and money laundering;
- regulatory amendments intended to limit the amount of cash a consumer can give an intermediary in connection with a financial transaction;
- regulatory amendments so as to allow the AMF to evaluate the outside business activities of intermediaries (firms or other entities), in particular by establishing disclosure requirements. This would allow the AMF to rule on these outside activities and to intervene where necessary.

3. FUNDAMENTAL OBJECTIVE OF A COMPENSATION SYSTEM (ISSUE 3)

3.1. Background

One major issue inherent in all compensation plans is the maximum amount of the indemnity granted. This ceiling largely depends on the objective sought by the compensation program. In other words, the amount of coverage offered by a compensation plan is directly tied to the objectives sought in providing compensation: total, partial or minimal compensation.

For example, if the objective is to ensure that consumers are in a position to afford their basic needs following a fraud, the ceiling will be lower. However, if the objective is to place the consumer back in the situation in which he was prior to the fraud, the ceiling will be higher and will be closer to the total sums lost.

Given the Compensation Fund's scope and its \$200,000 ceiling, it is currently among the most generous. It does not seem that there are any compensation schemes without a ceiling.

Several elements can explain a partial coverage of losses:

- Insofar as compensation is considered to fall within the public domain, it is not the State's role to offer complete and unlimited coverage;
- Since the extent of coverage is tied to the funding of the compensation program, any increase in coverage has consequences on the costs and on those responsible for funding the program;
- Given that the scope of coverage is liable to affect the risks assumed by consumers and intermediaries, complete coverage could foster a lack of accountability and encourage riskier, or even careless, behaviour.

The third issue therefore consists in arriving at a consensus on the fundamental objective of the compensation program.

3.2 Answers to questions asked

QUESTION 6.
Should the fundamental objective of compensation for victims of financial fraud in Québec be to enable victims:

a) to recover a level of resources needed to avoid abject poverty?

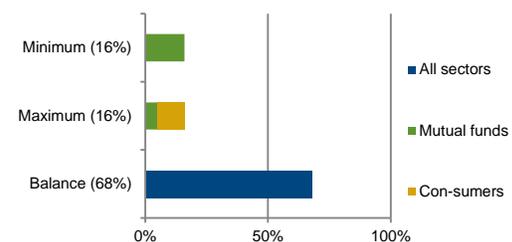
b) to recover the sums lost up to the very last dollar, regardless of the impact on costs, on the competitiveness of the industry or on the issue of accountability?

The majority of respondents were of the opinion that a balanced approach must be taken with respect to the recovery of sums lost by victims of financial fraud.

Of the 19 respondents who answered this question, 13 (68%) were in favour of striking a **balance**.

Three respondents (16%) were of the opinion that it would be best to allow victims **full recovery** of the sums lost, while three others (16%) were in favour of allowing only a **minimum recovery** of the sums lost.

CHART 5
Breakdown of respondents: Extent of recovery of sums lost (percentage)



Respondents **in favour of striking a balance** felt that the Fund's compensation model should be based on establishing a balance between the costs of the scheme and the risk of encouraging lack of accountability of the parties involved, while maintaining market competitiveness and consumer confidence in the financial markets.

A number of them were also of the opinion that a compensation limit is necessary and that the extent of coverage provided by the Fund should be the same for all, regardless of financial situation.

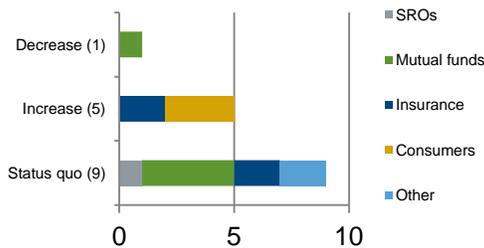
Some respondents also expressed the desire to see the limits and conditions of compensation clearly defined and disseminated.

QUESTION 7.
Should the current maximum compensation of \$200,000 be revised upwards or downwards?

A majority of the respondents felt that the Compensation Fund's existing ceiling is sufficient. In fact, 9 of the 15 respondents who answered this question were in favour of maintaining the **status quo**.

Five respondents favoured an **increase in the ceiling**, while only one was in favour of a **decrease in the ceiling**.

CHART 6
Breakdown of respondents: Revision of ceiling (in numbers)



The rate of abstention for this question was very high: 48% of the 31 briefs selected for analysis were silent on this specific question.

Based on the comments received, the low rate of response is largely attributable to the lack of information available to the respondents to help them answer the question.

Several of them indicated that it would have been useful for the AMF to provide information on the question and prepare scenarios based, in particular, on the claims history, the average assets held by investors

and the impact on the cost of funding the Fund.

Nonetheless, among those who answered, some stated that they would like to ensure that the maximum amount of the indemnity always covers the majority of claims, that this amount is indexed or revised regularly and that amounts are paid out in a fair manner.

Lastly, certain respondents mentioned that measures, such as a deductible and co-insurance, could be explored with a view to reducing the financial burden on the Fund. Given that these proposals tie in with elements of Issue 7, they will be discussed under that issue.

3.3 Conclusion

As mentioned earlier, consumers have a certain responsibility for managing their assets. However, a recent study of Québec investors' grasp of financial matters¹⁰ has shown that, for the time being, their financial knowledge is weak. For example, the study revealed that 59% of investors think there is no direct link between performance and risk.

Nevertheless, a compensation system that provides full and unconditional coverage for consumers would probably not be advisable, because it would have the effect of transferring a consumer's investment risk to the public authorities and, consequently, to all other consumers.

The consultation led to the following findings:

- 68% of respondents were of the opinion that a balanced approach must be taken with respect to the recovery of sums lost through fraud: While the scheme should not necessarily have as its objective to compensate for every last dollar lost, it should not be limited to the recovery of a minimum level of resources;

¹⁰ Cécile Carpentier and Jean-Marc Suret, "Connaissance financière et rationalité des investisseurs: une étude canadienne", September 1, 2011, available at: http://www.lautorite.qc.ca/files//pdf/education-financiere/connaissance-financiere-et-rationalite/CS_Connaissanceetrationalite2011.pdf (in French only).

- 60% of respondents felt that the existing \$200,000 ceiling is satisfactory.

Table 1 presents the breakdown of claims filed with the Compensation Fund since its creation in 1999.

TABLE 1

Breakdown of claims filed with the Fund between October 1, 1999 and March 31, 2011 (number and percentage)

Amounts claimed	No. of claims	Cumulative share (in %)
\$0 – 40,000	2,801	60.5%
\$40,000 – 80,000	876	79.4%
\$80,000 – 120,000	370	87.4%
\$120,000 -160,000	195	91.6%
\$160,000 – 200,000	157	95.0%
\$200,000 – 240,000	65	96.4%
\$240,000 – 280,000	45	97.3%
\$280,000 – 320,000	32	98.0%
\$320,000 – 360,000	18	98.4%
\$380,000 – 400,000	8	98.6%
+ than \$400,000	66	100.0%
Total	4,633	100.0%

The table shows that 95% of claims fell under the current \$200,000 limit. One can therefore conclude that the maximum indemnity covers the vast majority of claims.

It would obviously be possible to further expand the coverage by increasing the maximum amount of the indemnity.

However, claims exceeding \$200,000 are the exception.

Financing the compensation of this block of claims would therefore be very costly, because it represents the portion of claims that are the most substantial.

Therefore, the AMF makes the following recommendation:

- maintain the compensation ceiling at its current limit of \$200,000.** This amount could be reassessed in the future.

4. APPROACH WITH RESPECT TO CONSUMER COMPENSATION (ISSUE 4)

4.1 Background

A review of various compensation systems reveals two broad approaches.

In Canada, with the exception of the Compensation Fund, the approach is based primarily on funds set up to ensure the solvency of entities operating in the financial services field.

The aim is to protect consumers against the inability of firms to reimburse consumers' securities or funds.

The Compensation Fund uses a different approach. It compensates claimants regardless of the financial situation of the firm at fault. If the eligibility requirements are met, the consumer (claimant) is entitled to an indemnity.

The consumer must provide the AMF with evidence that he purchased a financial product or service and suffered harm. The process is similar to filing an insurance claim. Moreover, the consumer does not have to go before a third party decision-maker (court or arbitrator) to face the person who allegedly caused the harm.

After it compensates the claimant, the AMF institutes a subrogatory recourse against all entities considered at fault for the harm that was compensated.

It is therefore the AMF that initiates any proceedings to recover the sums paid by the Compensation Fund. On occasion, the entities sued declare bankruptcy and the amounts recovered, if any, are negligible.

The fourth issue therefore consists in determining whether the unique approach of Québec's Compensation Fund should be maintained or whether it should be harmonized with the practices observed in the rest of Canada.

4.2 Answers to questions asked

QUESTION 8.

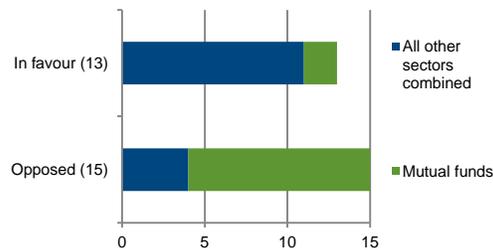
Should the uniqueness of Québec's compensation scheme be maintained? Would it be better to choose a system that more closely reflects practices outside Québec?

Answers to this question were very divided. Of the 28 respondents who answered this question, 15 were **opposed to maintaining the uniqueness of Québec's compensation scheme**, while 13 were **in favour of maintaining it**.

It should be noted that, of the 15 respondents who opposed maintaining Québec's uniqueness, 11 are from the mutual fund sector.

CHART 7

Breakdown of respondents: Maintain the uniqueness of Québec's compensation scheme (in numbers)



Respondents who **opposed maintaining Québec's uniqueness** essentially proposed a nation-wide harmonization of the rules applicable to the mutual fund sector. In other words, they suggested that Québec import the rules of the Mutual Fund Dealers Association of Canada (MFDA), recognize this organization as an SRO and make the Investor Protection Corporation (IPC) the organization that protects mutual fund investors.

They put forward the following arguments in support of their proposal:

- The MFDA's rules are more generous, because they cover the insolvency of firms for reasons other than fraud and because the compensation ceiling is set at \$1 million;
- The compensation system is more easily understood by consumers, because there is no need to prove fraud;
- Management of a compensation fund by an SRO allows for better investor protection, because there is greater proximity between the SRO and its members (market intermediaries);
- The internal problem-solving process that goes hand in hand with an insolvency-based system allows for a quick settlement of a number of disputes.

Respondents in favour of harmonizing the compensation rules formulated their answers based on the mutual fund sector, touching very little, if at all, on the insurance and financial planning sectors. Therefore, no proposals were made with respect to harmonization of compensation outside the mutual fund industry.

By contrast, respondents **in favour of maintaining the uniqueness of Québec's compensation scheme** had the following comments:

- Québec consumers enjoy better protection against fraud than consumers elsewhere in Canada;
- The existing system is straightforward, quick, fair and easily accessible to consumers;
- The existing system does not require consumers to exhaust all recourses and does not involve the judicial process, which is an advantage.

QUESTION 9.

Would the adoption of a compensation system based on the insolvency of firms be a way to provide more protection to consumers? Would it create a better balance between the extent of coverage and costs?

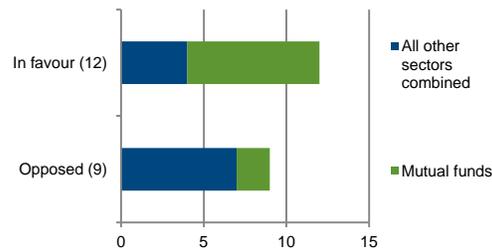
Of the briefs selected for analysis, 21 answered this particular question.

Of these 21 briefs, 12 respondents, the vast majority of them from the mutual fund sector, were of the opinion that a compensation system based on the insolvency of firms could be a **better way to protect consumers**, at a lower cost than the cost of the Compensation Fund.

The nine other respondents were of the opinion that, on the contrary, the **existing compensation system is preferable** to a system based on the insolvency of firms, because it is straightforward and accessible to aggrieved consumers.

CHART 8

Breakdown of respondents: Adoption of a compensation system based on insolvency (in numbers)



Several respondents also pointed out that fidelity insurance is available in Canada and could supplement coverage in the event of insolvency. This type of insurance provides firms with coverage against financial losses resulting from crimes committed by their employees, such as embezzlement, forgery, theft and fraud.

4.3 Conclusion

Respondents' comments did not really point to a finding in favour of the establishment of an insolvency-based system.

Instead, discussion of this issue brought back to the forefront the debate on **recognition by the Québec government of the MFDA as an SRO**.

From October 1 to November 30, 2010, the AMF held a consultation on the proposal of giving regulatory force to the compatible items of the MFDA regulations in order to finalize the implementation of a regulatory framework that is harmonized with the framework that applies in the rest of Canada.

The consultation document mentioned that the following Québec-specific aspects would be maintained for mutual fund dealers and representatives registered in Québec:

- Compulsory membership of representatives in the CSF, and payment of annual dues;
- Preservation of the CSF's authority with respect to discipline and compulsory professional development of representatives;
- Compulsory payment of the contribution by dealers to the Compensation Fund;
- Maintenance of the liability insurance plan to be subscribed to by dealers and their representatives registered in Québec.

The desire clearly expressed at that time favoured the uniqueness of Québec's system. However, the findings of that consultation and the Government's position on the matter are not yet known. Therefore, it is not possible to come to a conclusion on this proposal.

Several respondents who supported an insolvency-based compensation system argued that it forms the basis of the **compensation system established by the IPC**, that this system is superior to that of the Compensation Fund and that Québec should adopt it.

Clearly, if Québec were to join the IPC, this would have the advantage of harmonizing the Canadian compensation systems to a certain extent.

However, the ultimate aim of the Compensation Fund and the IPC differs. As mentioned above, the IPC seeks to protect consumers against the inability of firms to reimburse consumers' securities or funds. Therefore, in the event of fraud, the IPC offers consumers compensation if the fraud leads to the intermediary's insolvency.

The approach adopted by the Compensation Fund, however, seeks to compensate claimants regardless of the financial position of the firm in question. If the eligibility requirements are met, consumers who are the victims of fraud are entitled to an indemnity.

Moreover, the approach favoured in Québec allows consumers of financial products and services to benefit from a simplified claim system. By offering protection that covers the conduct of intermediaries carrying on activities in a number of sectors (insurance of persons, damage insurance, mutual fund brokerage, etc.), the Fund acts as a one-stop service outlet for the compensation of fraud victims.

In addition, it is interesting to note that the multidisciplinary nature of intermediaries is the rule rather than the exception (only 5.7% of claims for compensation received by the AMF involve representatives who do not have a history of multidisciplinary).

Under these circumstances, the AMF finds it difficult to see how joining the IPC would fully settle the lack of harmonization among Canada's compensation systems, since this approach would apply only to representatives of mutual fund dealers.

The other intermediaries (insurance representatives, claims adjusters and financial planners) would continue to be covered by a separate plan (the Compensation Fund), which would oblige consumers to deal with two organizations in order to obtain compensation for a fraud caused by a multidisciplinary intermediary.

Thus, on the whole, the current functioning of the Compensation Fund appears favourable to consumers.

Therefore, the AMF makes the following recommendation:

- **maintain the uniqueness of Québec's compensation scheme by retaining the Fund's current approach.**

5. RESPONSIBILITY FOR MANAGING COMPENSATION MECHANISMS INTENDED TO COMPENSATE VICTIMS OF FINANCIAL FRAUD (ISSUE 5)

5.1 Background

An indemnity must be granted in accordance with rules of fairness and administrative justice. The compensation process must be transparent and understandable from the point of view of victims.

The manager of a compensation fund is the trustee of the money entrusted to it by contributors. In order to fulfill its fiduciary obligations, the manager must rigorously manage claims and decide on the indemnities payable in accordance with the fund's rules.

The Compensation Fund is currently a separate patrimony constituted within the AMF, which is responsible for managing the Fund and ruling on the eligibility of claims submitted to it.

The administration of a compensation fund within a regulatory agency provides a number of significant benefits:

- It leads to faster decisions regarding compensation, in particular, because of the regulatory agency's knowledge of the market and its investigative functions;
- It allows consumers to benefit from the results of investigations carried out by the agency and avoid a multiplicity of administrative steps (evidence of misconduct or fraud is not easily accessed by consumers and requires complex investigations).

Nevertheless, some argue that the administration of a compensation fund within a regulatory agency may appear incompatible with the agency's oversight role. According to them, it may even give rise to governance issues based on the argument that the entity that establishes a regulatory system to govern practices should not be the one who decides to pay an indemnity if the system fails.

The fifth issue therefore consists in assessing whether the Compensation Fund's current governance is inadequate and, if so, in determining whether alternative mechanisms could reduce the risk of conflicts of interest,

whether real or apparent. Where applicable, it also consists in determining the potential impact of these alternative mechanisms on the compensation system.

5.2 Answers to questions asked

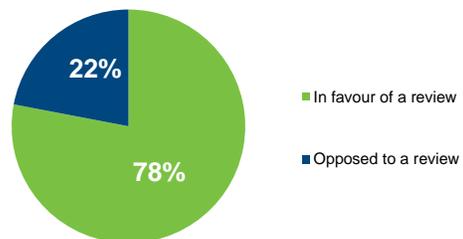
QUESTION 10.
Should the current governance of the Fund, which is administered as a separate patrimony by the AMF, be re-examined?

Of the 31 briefs selected for analysis, 27 answered this question.

Of the 27 respondents who answered, 21 of them (78%) were of the opinion that the governance of the Compensation Fund **should be reviewed**.

However, six respondents (22%) expressed satisfaction with the current governance of the Compensation Fund and stated that this governance model **should not be reviewed**.

CHART 9
 Breakdown of respondents: Review of the Fund's governance model (percentage)



Respondents **in favour of a review** of the Fund's governance felt that there is an appearance of conflict of interests, because the AMF acts concurrently as issuer of licences, regulator and compensation agency. According to them, the AMF may seem to be both a party to the proceedings and the decision-maker. Some even expressed the concern that the AMF could use the Compensation Fund to settle a situation for which it felt responsible. Others were of the opinion that the AMF's role should be to

supervise the operations of the Fund, rather than carry them out itself.

It is interesting to note, though, that of all these respondents, **none formulated a concrete reproach** about the way in which the AMF manages the Compensation Fund, notwithstanding the concern raised regarding the appearance of a conflict of interest.

Respondents who felt that the governance of the Fund **should not be reviewed** expressed the opinion that the current operation of the Fund has the advantage of providing a “one-stop service outlet.” According to them, the AMF is in the best position to act as trustee of the Fund because of its knowledge of the industry and its oversight functions. Furthermore, they pointed out that the integrated administration of the Compensation Fund makes it easier to pool the expertise of AMF staff, which provides a major advantage.

However, they emphasized the crucial importance of keeping the Fund’s patrimony separate from that of the AMF and ensuring that management of the Fund is transparent and fair at all times.

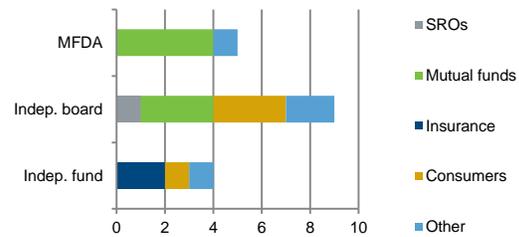
QUESTION 11.
If so, who would be better placed than the AMF to assume the fiduciary duty? Fund contributors? Consumers? Would there be a conflict of interest if contributors or consumers ruled on claims?

From among the 21 respondents in favour of a review of the Compensation Fund’s governance, 18 proposed alternatives to the current governance structure:

- Nine respondents proposed that the Fund be managed within the AMF, but through an **independent board of directors** or an **independent committee** with the power to make decisions or recommendations;
- Four proposed that the **Fund be managed totally independently** of the AMF, through an organization which could, for example, be composed of representatives of the industry, consumers and SROs;

- Five respondents proposed that the **MFDA be recognized** as an SRO and that it manage the compensation of fraud victims.

CHART 10
Breakdown of respondents: Proposals for reform of the Fund’s governance (in numbers)



QUESTION 12.
Would a court or an arbitrator limit the possibility of conflicts? Would increased independence adversely affect the simplicity of the compensation process for consumers?

Only 14 respondents answered this question. Seven were of the opinion that involving a court or arbitrator in the initial compensation process was not the solution, while seven were of the contrary opinion.

Respondents **in favour of court or arbitrator involvement** felt that this would be an interesting approach that could limit the risk of conflicts of interest. However, some acknowledged that the presence of a court or arbitrator could make the compensation process more complex and costlier.

Unfortunately, due to the paucity of answers received and the vagueness of a number of those answers, this part of the consultation is inconclusive.

QUESTION 13.

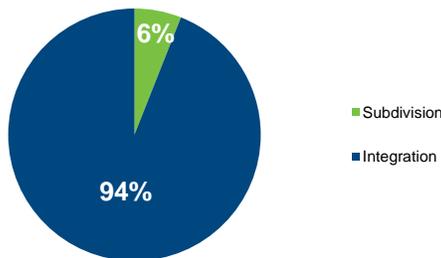
Given that fraud can be multidisciplinary or simultaneously involve various types of financial products and services, should we re-examine the integrated approach currently used in Québec, in other words, a single Compensation Fund to cover several types of financial services?

Lastly, as regards the question dealing with the Compensation Fund's integrated approach, only 17 briefs contained an answer.

A large majority of the respondents was in **favour of preserving the integrated approach** currently used in Québec. In fact, 16 of the 17 respondents (94%) preferred integration over a subdivided Compensation Fund.

CHART 11

Breakdown of respondents: Integrated approach of the Compensation Fund (percentage)



Respondents **in favour of integration** felt that access to a one-stop compensation outlet is the best option for consumers for whom it is already difficult enough to fully understand the various types of financial products and distinguish between the various sectors in which market intermediaries carry on their activities.

It should be noted that among respondents who favoured the integrated approach, some were of the opinion that the rate for contributions to the Compensation Fund should be established on the basis of the claims paid by the Fund among the various sectors.

Others also mentioned that only market intermediaries who have direct contact with consumers should be covered by the Compensation Fund.

Lastly, certain respondents pointed out that care must be taken to avoid potential overlaps between the Compensation Fund and other protection mechanisms.

5.3 Conclusion

Although respondents did not have specific complaints regarding the way in which the AMF administers the Compensation Fund, several of them were in favour of reforming the Fund's governance.

The majority of respondents who made proposals for modifying the Fund's governance suggested that it should continue to be managed within the AMF, but through an **independent board of directors** or an **independent committee** with the power to make decisions or recommendations.

In this regard, it is interesting to note that in 2007, following the Norbourg affair, the Government of Québec tabled Bill 64 (*An Act to amend the Act respecting the Autorité des marchés financiers and other legislative provisions*), which provided for the creation of an indemnity committee within the AMF. According to section 82 of that Bill, the function of the committee would have been to rule on the eligibility of claims submitted to the AMF and decide the amount of the indemnities to be paid. The committee was to have been composed of three members appointed by the Minister of Finance.

Although Bill 64 was assented to on May 28, 2008, section 82, which created the indemnity committee, never came into force.

Moreover, it is interesting to note that none of the respondents was able to formulate a specific reproach with respect to governance of the Compensation Fund. The establishment of a committee to rule on the eligibility of claims could have the effect of increasing the Fund's operating costs as well as waiting times for the processing of claims.

However, one of the solutions considered could see the committee entrusted with the task of examining applications for review filed by consumers, based on specific criteria that would preserve the AMF's jurisdiction. This solution would have the benefit of giving consumers access to a review by an

additional body, while preserving the AMF's integrated approach and providing for increased efficiency.

Lastly, of the respondents who were of the opinion that the Fund should maintain its integrated approach, some suggested that **the rate for contributions to the Compensation Fund should be established based on the claims** paid by the Fund among the various sectors.

In fact, contributions are already established, to a certain extent, according to the risk that each sector or sector class represents. This is a requirement under *An Act respecting the distribution of financial products and services*.

Moreover, since we are dealing with a Compensation Fund rather than an insurance contract, the contribution required from a given intermediary is determined by the risk his sector represents rather than by the risk the intermediary represents.

Thus, damage insurance representatives, insurance of persons representatives and

mutual fund dealer representatives pay an annual contribution of \$160, while financial planners and scholarship plan dealer representatives pay an annual contribution of \$100.

Therefore, the AMF makes the following recommendations:

- **maintain the system currently in place in Québec, namely, a compensation fund administered by the regulator:** This reduces processing times, and the regulator benefits from broad expertise created by the synergy of responsibilities (familiarity with the files, the issues, etc.);
- **introduce regulatory amendments so that the rules for eligibility of claims are clearer for the general public,** particularly the rules dealing with the time limit for filing a claim and the amount of eligible losses as well as the rules of evidence and procedure.

6. PRODUCTS, INTERMEDIARIES AND CONDUCT COVERED BY THE COMPENSATION FUND (ISSUE 6)

6.1 Background

In all the compensation systems reviewed, the eligibility of claims is governed by rules and the consumer must prove that he acted with reasonable care.

Generally speaking, in Québec, a claim filed with the Compensation Fund will be eligible when:

- The claim is filed within one year of knowledge of the alleged fraud, fraudulent tactic or embezzlement;
- The conduct in question involves market intermediaries who contribute to the Compensation Fund, namely, representatives governed by *An Act respecting the distribution of financial products and services* or mutual fund or scholarship plan dealer representatives governed by the *Securities Act*.
- The financial products or services covered by the claim are products or services that the market intermediary was authorized to offer within the limits of his certificate or registration;
- The alleged misconduct constitutes fraud, fraudulent tactics or embezzlement, in short, conduct that is intentional. Failure to fulfill professional obligations, errors, poor advice and negligence are covered by the professional liability insurance that intermediaries are required to purchase.

Since its establishment in 1999, the Compensation Fund has received 4,633 claims totalling \$283 million.

Of these, 1,399 claims met the eligibility criteria and resulted in the payment of \$49 million, that is, approximately 62% of the \$79 million claimed.

TABLE 2

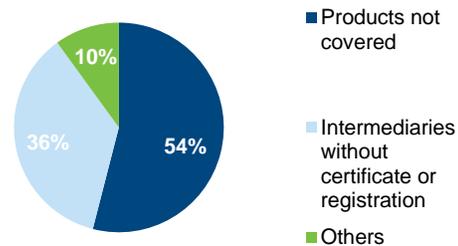
Claims filed with the Fund between October 1, 1999 and March 31, 2011¹¹
(in numbers and in millions of dollars)

Decision	No. of claims	Amount claimed	Amount paid
Granted	1,399	\$79 M	\$49 M
Rejected	3,234	\$204 M	\$ -
Total	4,633	\$283 M	\$49 M

However, 3,234 claims were rejected because they did not meet the Compensation Fund's eligibility criteria. The principal grounds for the rejection of claims are the sale of products not covered by the Fund (54% of rejections) and the involvement of intermediaries without a certificate or registration¹² (36% of rejections).

CHART 12

Breakdown of the principal grounds for the rejection of claims filed with the Fund between October 1, 1999 and March 31, 2011 (percentage)



Since every compensation system must have limits and it is difficult to imagine a protection

¹¹ The gap between the claims for \$79 million filed with the Fund and the \$49 million paid out stems primarily from the application of a \$200,000 ceiling (maximum indemnity) and from the fact that the Compensation Fund does not pay for moral damages, lost profits, redemption fees, lawyers' fees or other amounts that certain consumers add to their claims.

¹² This includes claims for compensation that were rejected because of the involvement of intermediaries who were not certified or registered, or were registered but did not contribute to the Fund, as well as claims rejected because the alleged fraud was committed outside the distribution system, regardless of whether or not an intermediary was involved.

program without a framework, rejected claims are often a source of dissatisfaction with respect to the Compensation Fund.

The scope of coverage offered by the Compensation Fund can be examined under four headings: intermediaries covered, products covered, conduct in question and maximum indemnity (ceiling).

6.1.1 Market intermediaries covered

The Compensation Fund does not currently cover all market intermediaries. Only consumers who deal with intermediaries governed by *An Act respecting the distribution of financial products and services* or with mutual fund or scholarship plan dealer representatives governed by the *Securities Act* are eligible to receive an indemnity from the Compensation Fund.

Investment dealers and fund managers are not covered.

6.1.2 Products covered

In order for a market intermediary's fraudulent conduct to be covered by the Compensation Fund, the conduct must involve products or services that the representative was authorized to offer. In other words, the claimant must show that the conduct falls within the limits permitted by the intermediary's certificate or registration, i.e. that it was committed within the purview of his practice as authorized by the AMF.

As chart 12 indicates, the most frequent ground for the rejection of claims relates to conduct that falls outside the limits permitted by the certificate or registration issued to the intermediary by the AMF.

6.1.3 Conduct eligible for compensation

At present, the scope of application of the Compensation Fund is limited to conduct considered intentional and wilful, namely:

- fraud;
- fraudulent tactics; and
- embezzlement.

Such intentional conduct is not generally covered by the professional liability insurance of intermediaries.

Other acts likely to have a negative impact on consumers, such as breaches of obligations, errors, poor advice or negligence, are not covered by the Compensation Fund. Instead, they are covered by the professional liability insurance that intermediaries are required to carry in order to be authorized to practise in Québec.

Gross negligence is also not covered by the Compensation Fund. Moreover, its coverage under liability insurance contracts has been the subject of much discussion, with the debate on the issue having recently been brought before the courts.¹³

Some hold the opinion that liability insurance should cover the gross negligence of intermediaries, regardless of the type of fault committed. Others argue that gross negligence is intentional and, consequently, should not be covered by the liability insurance of intermediaries. In fact, a growing number of liability insurers are refusing to cover gross negligence.

The sixth issue therefore consists in determining the appropriate scope of coverage offered by the Compensation Fund. This requires a consideration of the resulting costs and economic impact as well as issues pertaining to the accountability of consumers and market intermediaries.

¹³ *Souscripteurs du Lloyd's v. Alimentation Denis & Mario Guillemette inc.*, 2012 QCCA 1376, leave to appeal rejected by the Supreme Court on April 4, 2013 (file 35011); *Audet v. Transamerica Life Canada*, 2012 QCCA 1746, leave to appeal rejected by the Supreme Court on April 4, 2013 (file 35098).

6.2 Answers to questions asked

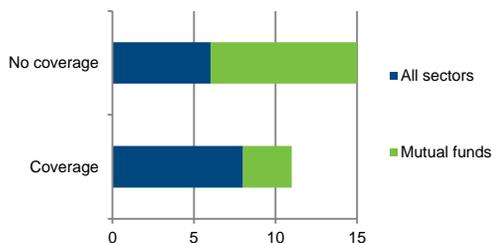
QUESTION 14.

Should the conduct covered by compensation include conduct that falls outside the limits permitted by an intermediary's certificate or registration? For example, if a representative in insurance of persons (life and health) commits mutual fund fraud, should his actions be covered by the Compensation Fund?

Of the 31 briefs, 26 answered this question. Of the 26 respondents, 11 were **in favour** of covering conduct that falls outside the limits permitted by an intermediary's certificate or registration. The other 15 were **opposed** to expanding the coverage, opting instead for the status quo. Interestingly, 9 of these 15 respondents are from the mutual fund sector.

CHART 13

Breakdown of respondents: Coverage of conduct that falls outside permitted limits (in numbers)



Respondents **in favour of expanding the coverage** felt that consumers should not bear the burden of distinguishing between the products offered and determining whether their representative had the right to offer those products, based on the permit held. According to them, consumers have few reference points to assist them and it may be difficult or impossible for them to understand a product and its distribution method. They were of the opinion that the Fund should compensate consumers who have been defrauded, regardless of the type of product sold to them.

Respondents **opposed to expanding the scope of coverage** relied principally on the issue of consumer accountability to support their opinions. They argued that greater coverage encourages less consumer

accountability. They generally felt that consumers have a minimum obligation to check their representative's registration and scope of activity.

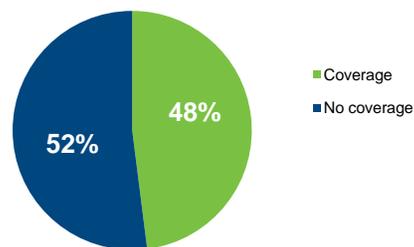
QUESTION 15.

Should the Compensation Fund coverage be extended to all entities registered with the AMF, including investment dealers and fund managers?

Answers to this question were very divided. Of the 27 briefs that answered this question, 13 respondents (48%) were **in favour of extending the scope** of coverage of the Compensation Fund to investment dealers and fund managers, while 14 respondents **opposed this suggestion**.

CHART 14

Breakdown of respondents: Coverage of fund managers and investment dealers (percentage)



Respondents **in favour** of expanding coverage were generally of the opinion that Compensation Fund coverage should apply to the entire financial products distribution chain. However, they did not provide reasons in support of their answers.

Respondents **opposed** to expanding coverage were mainly concerned with the additional costs such an expansion would entail. A number of them were concerned about the effect of expanding coverage on the balance and equitable financing of the Compensation Fund.

Others argued that investment dealers and fund managers are already sufficiently covered by existing compensation mechanisms in the securities industry. According to them, requiring investment dealers and fund managers to pay into the Compensation Fund would constitute a

duplication of coverage and costs that would benefit neither consumers nor intermediaries.

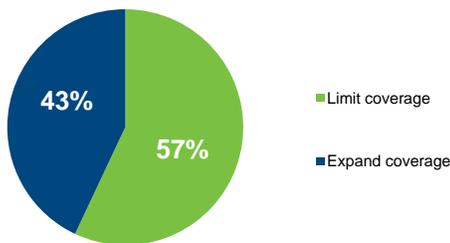
Regardless of their respective positions, certain respondents reiterated that the rate for contributions to the Compensation Fund should be based on claims paid by the Fund among the various sectors or sector classes.

Others also reiterated that only market intermediaries who have direct contact with consumers should be covered by the Compensation Fund.

QUESTION 16.
Should the Compensation Fund coverage be limited to conduct currently covered, i.e. fraud, fraudulent tactics and embezzlement?

Here too, answers to this question were very divided. Of the 23 respondents who answered the question, 13 (57%) were in favour of **limiting the coverage** of the Compensation Fund to conduct currently covered while 10 (43%) were in favour **of extending the coverage** to other conduct.

CHART 15
 Breakdown of respondents: Limit to conduct currently covered (percentage)



Some of the respondents **in favour of limiting the coverage** argued that the Compensation Fund was created to address regulatory gaps in consumer protection. According to them, the Fund's existing coverage is sufficient and should be limited to dealing with that issue.

Some of the respondents **in favour of expanding the coverage** felt that gross fault and gross negligence should be covered by the Compensation Fund.

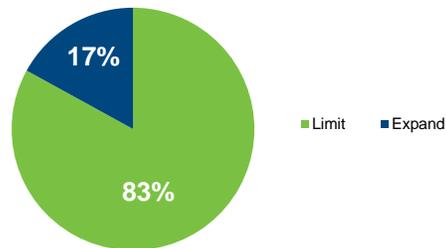
Moreover, certain respondents, regardless of their opinions on the issue of expanding the

Fund's coverage, argued that the compensation of consumers should be tied to the insolvency of firms. They felt that coverage based on insolvency was an interesting approach, because it allows for compensation without the need to qualify the nature of the conduct that caused harm to the consumer.

QUESTION 17.
Should we instead expand the coverage to include gross negligence, errors, omissions and any other failure?

This question is closely related to the preceding one. Surprisingly however, the answers to the two questions were not consistent. Of the 23 respondents who answered this question, 19 (83%) were **opposed to the idea of covering all failures**, while only four (17%) were in favour of the idea that **all failures should be covered**.

CHART 16
 Breakdown of respondents: Expanding coverage to other conduct (percentage)



Respondents **opposed to expanding** the Compensation Fund's coverage to other conduct were of the opinion that the Fund should avoid duplicating the coverage generally offered by intermediaries' liability insurance. According to them, gross fault and negligence, in particular, should remain exclusively under insurance coverage.

Respondents **in favour of expanding** the Compensation Fund's coverage to other conduct were of the opinion that the expansion should be limited to gross fault and gross negligence.

QUESTION 18.

What would the implications be? For example, would there be a risk of overlapping with other compensation programs or professional liability plans?

Of the respondents who answered, 89% (16 of 18) felt that expanding the range of conduct covered by the Compensation Fund would necessarily result in **undesirable consequences**.

Several were of the opinion that such an expansion would significantly increase the number of claims filed with the Fund and, in turn, the costs associated with the Fund. They also felt that expanding the range of conduct would create a coverage overlap as well as conflicts between the various protection mechanisms currently in place, in addition to increasing the risk of lack of accountability.

6.3 Conclusion

Answers to the questions on this issue were very divided, regardless of the group to which the respondents belong. Consequently, it is difficult to draw a clear conclusion as to the preferred scope of coverage of the Compensation Fund.

Nonetheless, in the AMF's opinion there should be certain restrictions when compensating victims to account for:

- Market vagaries and movements;
- The personal activities of market intermediaries;
- Fraud committed by issuers;
- Illegal investments;
- Activities carried out by uncertified or unregistered persons.

However, adjustments could be considered in order to tailor the Compensation Fund's coverage to meet the needs of consumers and industry members, particularly as regards intermediaries covered, products covered and conduct covered.

Intermediaries covered

The question on the coverage of investment dealers and fund managers generated very divided answers.

Based on a preliminary estimate, the decision to **expand coverage to investment dealers** could increase the annual cost of the Compensation Fund by \$3 million and allow coverage for an additional 11,000 intermediaries.

Currently, investment dealers contribute to the Canadian Investor Protection Fund (CIPF). If they were covered by the Compensation Fund, this coverage would not replace CIPF coverage. It would supplement it and could cause an overlap and duplication. Such an approach could also create disharmony in an area that is highly harmonized.

In addition, the AMF is not currently in a position to make recommendations on this proposal, because it is a complex issue that requires additional work involving, among others, the Investment Industry Regulatory Organization of Canada.

As for the possibility of expanding **coverage to investment fund managers**, it should be noted that since the establishment of the Compensation Fund, measures to bolster regulations have been implemented in order to govern the activities of investment fund managers. In particular, since 2009, investment fund managers have been required to register with the AMF in order to pursue activities. This new registration category is intended to ensure that fund managers meet the requisite standards of competence, integrity and solvency.

Moreover, as some respondents mentioned, the role of fund managers in the financial product distribution chain is that of "manufacturers." They have no contact with the public and do not act as advisers to consumers.

In fact, a fund manager who wishes to distribute fund units directly to consumers must register as a dealer. Similarly, a fund manager who wishes to provide advice regarding the investment fund must register as a portfolio manager.

The mission of the Compensation Fund is to compensate consumers who have been defrauded in the course of an offering of financial products and services, that is, in a situation involving the distribution of financial

products and services, not their “manufacture.”

Based on a preliminary estimate, the decision to **expand coverage to investment fund managers** would cost \$7.5 million and allow for the coverage of 92 investment fund managers, representing a cost of approximately \$81,500 per investment fund manager. There is a risk that the increased cost of this new class of “intermediaries” could be indirectly passed on to consumers through the various management fees associated with the products and have a negative impact on the profitability of their investments.

Within the scope of this consultation, the AMF was unable to identify a consensus on the issue of coverage by the Compensation Fund of investment dealers and investment fund managers.

Consequently, and in light of the significant costs of extending coverage, the AMF makes the following recommendation:

- **maintain the Compensation Fund’s current scope of application regarding the intermediaries covered.**

Products covered

As mentioned above, the most frequent reason for rejecting a claim is conduct that falls outside that permitted by the certificate or registration issued to the intermediary by the AMF.

With the world of finance constantly changing and the number of ever more complex products increasing, it can be difficult for consumers to determine which products and services an intermediary is actually authorized to offer.

Moreover, over the past few years, the AMF has emphasized how important it is for consumers to verify that their representative is registered with the AMF. Fraud awareness campaigns aimed at Québec consumers are a good example of the importance the AMF has placed on this preliminary step.

Consequently, it would be desirable to provide coverage to consumers when they deal with intermediaries who are duly certified or

registered in one of the sectors covered by the Fund, whether or not the claim pertains to conduct that falls outside that permitted by the certificate or registration issued by the AMF.

Based on a preliminary estimate, expanding the scope of application of the Compensation Fund to conduct that falls outside that permitted by an intermediary’s certificate or registration would increase the Compensation Fund’s costs by \$4.9 million.¹⁴

Therefore, the AMF makes the following recommendation:

- **introduce legislative amendments with a view to applying the compensation mechanisms to any fraud, fraudulent tactic or embezzlement committed by an intermediary in the pursuit of his activities, regardless of the nature of the products offered, provided the intermediary is registered with the AMF and has contributed to the Compensation Fund.** This means expanding the current scope of application of the Compensation Fund as regards the products covered, so that consumers can be indemnified even for claims pertaining to conduct that falls outside that permitted by the certificate or registration issued by the AMF. The proposed scope of application is nevertheless limited to professional activities and excludes personal activities.

Conduct covered

The consultation contained three questions in connection with this aspect.

Unfortunately, as mentioned above, the answers to these questions were inconsistent and, at times, contradictory. It is therefore impossible to draw a clear conclusion.

It should be noted that expanding the Compensation Fund’s coverage to include **errors and omissions** would entail costs corresponding to the risk currently assumed by intermediaries’ liability insurers, insofar as such conduct were no longer covered by

¹⁴ These estimates do not include any margin of flexibility for contingencies or for the accumulation of a reserve.

these insurers. This would involve a transfer of risk (i.e. costs and contributions), rather than an additional risk assumed by the industry.

However, if such conduct were still covered under liability insurance contracts, the expanded coverage would create an overlap between the protection offered by the Compensation Fund and that offered by liability insurance.

Furthermore, the overlap would likely cause some of the claims intended for liability insurers to be transferred to the Compensation Fund, particularly because of its simplified and low-cost claim mechanism, undoubtedly resulting in a significant impact on the costs of the Fund.

In light of the foregoing, the AMF is of the opinion that expanding the Compensation Fund's coverage to include errors and omissions is neither timely nor advisable.

As for coverage of **gross fault** by the Compensation Fund, this is not an avenue being considered. The AMF is of the opinion that gross negligence is and must remain within the ambit of liability insurance. In fact, the applicable regulations provide that the liability insurance of intermediaries must cover their fault, regardless of the type of fault committed.¹⁵

Nonetheless, in the past few years, the debate over coverage of gross fault under liability insurance contracts of intermediaries has revealed a problem of interpretation which must be clarified so as to protect consumers. Insofar as gross negligence is not covered by the Compensation Fund, consumers must not be left unprotected in situations in which a liability insurer refuses coverage for an intermediary's gross fault.

Therefore, the AMF makes the following recommendations:

- **maintain the Compensation Fund's current scope of application regarding the conduct covered;**
- **ensure that unintentional gross negligence is covered under the liability insurance contracts of intermediaries.**

¹⁵ *Securities Regulation* (c. V-1.1, r. 50), section 193, *Regulation respecting the pursuit of activities as a representative* (c. D-9.2, r. 10), section 17 and *Regulation respecting firms, independent representatives and independent partnerships* (c. D-9.2, r. 2), section 29.

7. FUNDING THE COMPENSATION FUND AND COST CONTAINMENT MEASURES (ISSUE 7)

7.1 Background

The Compensation Fund's average annual funding needs are estimated at \$5 million and do not currently require any direct contribution from consumers.

The Compensation Fund has three sources of funding:

- Contributions paid by the firms of the market intermediaries covered by the Compensation Fund (93% of the Compensation Fund's income since its creation in 1999);
- Amounts recovered through subrogatory recourses initiated by the AMF (5% of the Compensation Fund's income since its creation in 1999);
- Interest income (2% of the Compensation Fund's income since its creation in 1999).

It should be noted that the contribution rate required from industry members does not provide for the accumulation of a reserve. Contributions are adjusted according to the Fund's financial needs. Thus, when there are few claims, contribution rates can be very low. However, when a major fraud occurs, contribution rates can be significant, as was the case in recent years.

Several measures could be considered in order to reduce the financial burden on the Compensation Fund. Four of these measures were examined: a deductible, co-insurance, bonding and a reduction in the indemnity ceiling.

7.1.1 Overview of cost containment measures

a) Deductible

The deductible is the portion of the risk that the insured (or the claimant) assumes. Imposing a deductible would result in a victim of fraud not being compensated for the initial portion of the financial loss.

This mechanism is common in damage insurance (for example, the consumer

assumes the first \$250 or \$500 of damage if he has an accident with his automobile).

Introducing a deductible could make consumers more accountable and reduce the number and cost of claims.

(b) Co-insurance

Co-insurance is the percentage of the cost of a claim that the insured (or the claimant) assumes.

If co-insurance were introduced, a victim of fraud would have to assume a percentage of the eligible claim, up to the amount of the maximum indemnity. For example, if co-insurance equal to 10% were applied, the victim would receive 90% of the indemnity and would therefore have to assume the remaining 10%.

While co-insurance would not reduce the number of claims, it could make consumers more accountable and reduce the cost of claims.

c) Bonding

A bond is security that is used to repay the sums owed to a creditor if the debtor fails to perform his obligations.

For example, the *Regulation respecting travel agents* (c. A-10, r. 1) requires each travel agent to have individual security to guarantee to his customers the performance of the obligations in mandates given to him. One of the purposes of bonding is to reimburse a customer for a sum he paid to the travel agent for a service not rendered. In the case of the Compensation Fund, the existence of a bond would mean that, in the event of fraud, the bond amount would be used first to fund the compensation of victims.

Bonding would have the advantage of reducing the Fund's financial risk without adversely affecting the compensation of victims.

d) Maximum indemnity (ceiling)

In the discussion of Issue 3, the question of the indemnity ceiling was broached from an ideological perspective, i.e. the fundamental objective of compensation of victims of financial crime.

The subject can also be analyzed from an economic perspective. The amount of the maximum indemnity could in fact be decreased. Doing so would reduce the costs of the compensation program and encourage consumers to exercise care and be accountable. Like a deductible, this measure would likely reduce the number of eligible claims.

However, an overly low ceiling could conflict with the fundamental objective of the Compensation Fund.

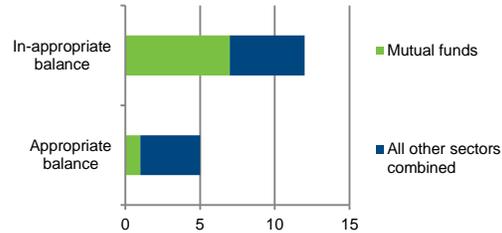
The seventh issue therefore consists in finding a balance between the Compensation Fund's scope of coverage and its costs. It also consists in determining whether it would be appropriate to consider measures to limit these costs and the variability of contribution rates in the event of fraud.

7.2 Answers to questions asked

QUESTION 19.
 Considering the extent of coverage of the Fund, its costs and economic consequences, as well as its potential effect on the conduct of consumers and market intermediaries, is the current balance between these elements appropriate? If not, in which direction should the balance be shifted and what are the implications of doing so?

Although only a few respondents answered this question, their answers were quite clear-cut. Of the 17 respondents who answered this question, 12 were of the opinion that the balance between the extent of coverage of the Fund, its costs and economic consequences and its potential effect on the conduct of consumers and market intermediaries is **inappropriate**. On the contrary, five respondents were of the opinion that the balance is **appropriate**.

CHART 17
 Breakdown of respondents: Fund cost/coverage balance (in numbers)



The majority of respondents therefore felt that the balance is **inappropriate**. However, their explanations in support of this position did not indicate precisely how the balance is inappropriate or how it should be shifted.

Several respondents were of the opinion that the Fund is inequitable and that the inequity could be remedied by establishing contributions on the basis of the risk that each contributor represents.

Moreover, a number of respondents suggested that fraud prevention measures should be improved through enhanced information and education programs and tighter supervision of intermediaries registered with the AMF.

It is interesting to note that respondents who were of the opinion that the existing balance is **appropriate** suggested, as did the others, that consumer education and intermediary oversight were essential for maintaining this balance.

QUESTION 20.
 What impact could Compensation Fund costs have on the availability and quality of financial products, as regards expected returns, the level of risk assumed and product characteristics for purposes of diversification?

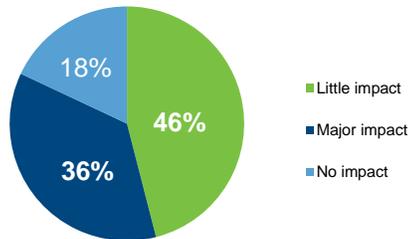
Very few respondents – only 11 of the 31 briefs selected for analysis – answered this question.

Of these, four (36%) were of the opinion that the costs associated with the compensation mechanism would be likely to have a **major**

impact on the availability and quality of financial products. Five (46%) were of the opinion that these costs would have **little impact**, while two (18%) felt they would have **no impact**.

CHART 18

Breakdown of respondents: Impact on availability and quality of products (percentage)



Respondents who felt that the costs associated with the Fund were likely to have an **impact (whether major or minor)** on the availability and quality of the products offered to Québec consumers were primarily concerned with their effect on the rates of return of products offered to Quebeckers.

These respondents explained that compensation costs are reflected in the rates for financial products and services, because they are generally passed on to consumers through the various administrative fees associated with the products.

They were of the opinion that increased coverage, which would lead to increased funding costs for the Compensation Fund, would result in more expensive products, making them less competitive and attractive. Although increased compensation costs would not affect the quality of products as such, they would directly affect product availability and rates of return.

QUESTION 21.

Should we implement cost containment measures and increase the accountability of consumers and market intermediaries? If so, what should these measures be and why? What are the pros and cons of such measures? What outcomes should we strive to achieve or avoid?

This question gave rise to 22 answers from the stakeholders who participated in the consultation. Of these, 19 respondents (86%) were in favour of **implementing cost containment measures and increasing the accountability** of consumers and market intermediaries, while the other three respondents (14%) felt that the **current measures are adequate**.

Respondents who were of the opinion that **measures should be implemented to contain costs and increase accountability** proposed several solutions. Some respondents proposed more than one measure. The principal proposals are as follows:

- Six respondents stated that prevention and education are the best measures to contain costs and make consumers and intermediaries accountable;
- Three respondents stated that subrogatory recourses should be used more aggressively;
- Three respondents were in favour of co-insurance;
- Two respondents suggested that fines collected could be used to finance the Fund;
- Two respondents were in favour of setting up a program to encourage and protect whistleblowers;
- One respondent reiterated that a centralized register would be beneficial;
- One respondent was in favour of imposing a deductible.

QUESTION 22.

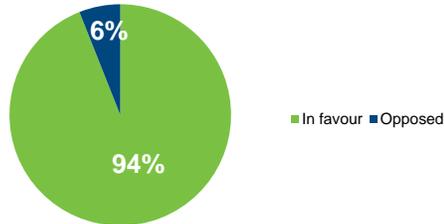
To what extent should the Compensation Fund adopt capitalization measures to ensure its survival and limit the variability of contribution rates in the event of a major fraud?

Few respondents broached this question. Of all the briefs selected for analysis, only 18 contained an answer to this particular question.

Of these 18 respondents, 17 (94%) were **in favour** of the adoption of capitalization measures and one respondent (6%) was **opposed** to the adoption of such measures.

CHART 19

Breakdown of respondents: Adoption of capitalization measures (percentage)



The majority felt that the Fund should adopt a preventive approach allowing it to establish a reserve in the event of a major fraud. One of the suggestions for achieving this goal was to set contribution rates slightly higher than necessary, so as to limit the variability of contribution rates and ensure the survival of the Fund.

7.3 Conclusion

Overly generous compensation is liable to have a negative effect on consumer and intermediary accountability.

As some respondents stated, an overly high or poorly designed rate structure could have several adverse effects, such as:

- A less attractive and less diversified offering of financial products;
- A lower long-term return for Québec investors and less opportunities for diversification;
- A less dynamic financial industry in Québec than in the rest of Canada.

Cost containment measures could stabilize or even reduce the rate for contributions to the Compensation Fund.

These measures could also encourage consumers to be more prudent, because they would be required to assume a greater share of the financial risk associated with a fraud.

Question 21, which dealt with cost containment measures, elicited several responses and suggestions from respondents.

However, there was no consensus on which measures should be given priority.

Clearly, these measures would impact the cost and/or number of claims eligible for compensation by the Compensation Fund, as illustrated below.

Deductible

The impact of a deductible on the cost and number of claims eligible for compensation is directly related to the amount of the deductible selected.

By introducing a deductible, a victim would not be compensated for the initial portion of his loss, which would reduce the number of claims and have a direct impact on small claims. For example, if a victim had to assume the first \$1,000 or \$2,000 of a financial loss, he could be deprived of an indemnity if the amount of his claim were lower than the amount of the deductible.

Table 3 illustrates scenarios with a few different deductibles.

TABLE 3

Illustration of the impact of introducing a deductible on the cost and number of claims filed with the Fund (in numbers and in millions of dollars)

Deductible	Compensation paid since 1999	Reduction with respect to status quo (\$M)	No. of eligible claims
Status quo	48.8	Nil	1,399
\$2,500	45.5	- 3.3	1,254
\$5,000	42.6	- 6.2	1,096
\$7,500	40.0	- 8.8	973
\$10,000	37.7	- 11.1	861

Thus, the higher the deductible, the greater the reduction in the number of eligible claims and in indemnities paid.

This approach would limit access to compensation and may not be desirable, because the objective is not to reduce the number of small claims.

Furthermore, given that the size of claims varies significantly from one sector to another, imposing a deductible could have a greater adverse effect on certain sectors.

TABLE 4
Average indemnity by sector
(in numbers and in dollars)

Sector	No. of claims	Average indemnity paid
Group insurance of persons	12	\$6,962.43
Damage insurance	229	\$19,817.82
Insurance of persons	187	\$27,009.07
Mutual fund brokerage	966	\$40,072.49
Financial planning	5	\$65,419.71
Overall total	1,399	\$34,817.48

For these reasons, the AMF is of the opinion that the introduction of a deductible should not be considered.

Co-insurance

With co-insurance, a fraud victim would be expected to assume a percentage of the eligible claim up to the amount of the maximum compensation. For example, if co-insurance were set at 15%, the victim would receive only 85% of the eligible compensation and would therefore be expected to assume the remaining 15%.

The introduction of co-insurance would allow for a cost reduction equal to the percentage of co-insurance applied.

However, unlike a deductible, co-insurance would not impact the number of claims eligible for compensation. Both small and large claims would be eligible.

Table 5 presents the financial impact of various possible co-insurance scenarios.

TABLE 5
Illustration of the impact of introducing co-insurance on the Fund's costs
(in millions of dollars)

Percentage of co-insurance	Compensation paid since 1999	Reduction with respect to status quo
Status quo	48.8	nil
5%	46.4	- 2.2
10%	43.9	- 4.9
15%	41.5	- 7.3
20%	39.1	- 9.7
25%	36.6	- 12.2

This solution is interesting because it has an impact on all claims filed, without limiting accessibility.

Therefore, the AMF proposes to consider co-insurance as a cost reduction measure.

Co-insurance could be introduced when extending coverage. This would limit the impact on contributors, who are the main source of funding of the Compensation Fund.

Bonding

Bonding would have a similar impact on the cost of the Compensation Fund as a deductible.

The major difference between the two is that, in the case of bonding, it is not the consumer who absorbs the initial portion of the loss.

Table 6 presents a few scenarios involving bonding.

TABLE 6

Illustration of the impact of introducing bonding on the Fund's costs
(in millions of dollars)

Amount of the bond	Compensation paid since 1999	Reduction with respect to status quo
Status quo (Ø bond)	48.8	nil
\$2,500	48.6	- 0.2
\$5,000	48.3	- 0.5
\$7,500	48.1	- 0.7
\$10,000	47.8	- 1.0

Nonetheless, although bonding has the possible advantage of reducing the financial risks assumed by the Fund, it would have an administrative impact, by imposing a cost on intermediaries and by requiring the AMF to monitor the obligation to maintain bonding.

For these reasons, the AMF is of the opinion that the introduction of bonding should not be considered.

Reducing the indemnity ceiling

Table 7 illustrates the financial impact of three possible scenarios involving a decrease in the indemnity ceiling.

TABLE 7

Illustration of the impact of reducing the Fund's indemnity ceiling
(in millions of dollars)

Indemnity ceiling	Compensation paid since 1999	Reduction with respect to status quo
Status quo (\$200,000)	48.8	nil
\$150,000	46.0	- 2.8
\$100,000	41.1	- 7.7
\$50,000	31.5	- 17.3

As Table 1 illustrates, over 80% of claims are filed for amounts under \$100,000. Thus, in order to realize substantial savings, the indemnity ceiling would have to be lowered significantly, which the AMF does not believe is advisable.

Therefore, the AMF is of the opinion that a reduction in the indemnity ceiling should not be considered.

Use of fines collected to finance the Fund

As mentioned above, some respondents suggested that the AMF use the fines collected, or a portion thereof, in order to finance the Compensation Fund.

The Compensation Fund is currently funded through the contributions paid by intermediaries and the amounts recovered through subrogatory recourses. These amounts are managed by the AMF with separate accounting records, as a patrimony distinct from that of the AMF. The Fund's administrative and operating costs are paid from the sums comprising the Fund.

Any fines collected are not paid into the Fund. They form part of the AMF's patrimony, and a portion of these fines is paid into the Education and Good Governance Fund.

Using a portion of the fines collected in order to finance the Fund would reduce the financial burden on intermediaries and, ultimately, on consumers.

If this approach were to be adopted, additional efforts would be required to measure its impact effectively. Therefore, the AMF is of the opinion that the use of fines collected to finance the Fund is not a desirable short-term solution.

Program to encourage and protect whistleblowers

There is no whistleblower program as such.

However, since the fall of 2011, *An Act respecting the Autorité des marchés financiers* has provided protection for whistleblowers. Under the Act, a person of good faith who reports a failure to comply with

a statute the AMF is required to administer is not subject to any civil liability for doing so.

Therefore, the AMF is of the opinion that the elements of this proposal have already been implemented.

Capitalization of the Fund

The Fund could seek to capitalize itself in order to limit the variability of contribution rates and avoid contribution rate increases that are excessive for the industry. The vast majority of respondents supported this idea.

Moreover, a comparison of various Canadian protection funds indicates that the Compensation Fund is one of the least well-capitalized funds (if not the least capitalized). In fact, the Compensation Fund's capitalization as at March 31, 2012 would not be sufficient to cover the average annual compensation expenditure (see Table 8).

By comparison, the Real Estate Indemnity Fund, which was established in 2010, is already better capitalized than the Compensation Fund.

TABLE 8

Comparison of the capitalization of the Compensation Fund with other Canadian compensation funds

Organization	Capitalization as at the past annual report (in \$M)	Maximum compensation (historical)	Average annual compensation	Date of annual report	Ratio of capitalization/ average compensation
Compensation Fund	1.54	\$32,000,000	\$2,980,000	March 31, 2012	0.51510067
Assuris	121.40	\$180,000,000	\$9,761,904	June 30, 2011	12.4359998
Real Estate Indemnity Fund	3.19	\$144,360	\$107,000	December 31, 2011	29.7675327
Compensation fund for customers of travel agents	67.25	\$1,858,719 (*)	\$835,000	March 31, 2011	80.5350132
CIPF	420.20	\$15,531,793	\$1,000,000	December 31, 2011	420.201899
IPC of the MFDA	30.27	\$66,370	\$9,481.43	June 30, 2011	3192.58008

(*)The maximum indemnity per incident, formerly set at \$3 million, can no longer exceed 20% of the accumulated surplus in the fund as at March 31 prior to the incident. However, it cannot be less than \$5 million.

In the same manner as insurers establish reserves to satisfy claims through the insurance premiums collected from insureds, capitalization of the Fund would allow it to satisfy claims for compensation. The concept of mutualization on which insurance is based makes it possible to distribute the impact of a loss sustained by one individual over all of the insureds. This principle also applies to the Fund.

Thus, like insurers do, the Fund could estimate the contribution rate needed to achieve a capitalization goal over a given period of time. Having reached its target, the Fund would reduce the contribution rate to reflect its new situation. *Ex-ante* capitalization

of the Fund, i.e. capitalization prior to a loss, would have the advantage of collecting contributions from potential fraudsters before the fraud occurs.

The Fund's capitalization target would vary based on its objectives.

For example, the Fund could be capitalized until it is **administratively self-sufficient**, i.e. until the capitalization could provide investment income to cover all of the Fund's administrative expenses, which currently amount to \$1.521 million.¹⁶ Once the objective

¹⁶ Based on the 2010-2011 Annual Report available at <http://www.lautorite.gc.ca/files/pdf/publications/autorit>

has been reached, contributions would be used solely to pay indemnities.

The capitalization target would also provide the Fund with reasonable flexibility in the event of a major fraud. The long-term horizon provided by a capitalization target would allow the Fund to limit the variability of contribution rates.

Full capitalization of the Fund until it is completely self-sufficient would make it possible to eliminate the contribution once the target had been reached. However, such a target would impose a major burden on contributors. This option would not exclude the possibility for the Fund to reconsider its decision to eliminate the contribution if a major loss were to occur.

However, the costs associated with full capitalization of the Fund are excessive compared with the somewhat unpredictable and uncertain nature of major frauds.

Moreover, in the event of a disaster and insufficient assets in the Fund, section 278 of *An Act respecting the distribution of financial products and services* already allows the AMF to determine the contribution so as to make up the insufficiency over a maximum period of five years (special contribution).

Finally, it would be possible to set a **capitalization target that falls midway** between administrative self-sufficiency and complete self-sufficiency of the Fund.

In light of the foregoing, the AMF makes the following recommendations:

- **introduce legislative amendments to establish a 15% co-insurance as a cost containment measure;**
- **undertake work with a view to placing greater emphasis on the risk associated with each sector for purposes of determining the contribution rate and setting an appropriate capitalization target;**
- **undertake work aimed at identifying measures to improve the rate of recovery in subrogatory recourses.**

CONCLUSION

Québec has set up a Fund to compensate fraud victims. This system complements the protection mechanisms for financial institution insolvency, the remedies available for misconduct and conservatory measures.

The Compensation Fund's eligibility criteria and \$200,000 ceiling make it one of the most generous compensation schemes. A majority of those who responded to the consultation were of the opinion that the Fund is essential for maintaining consumer confidence.

Nevertheless, its operation is poorly understood and the financial frauds that have occurred in recent years have highlighted this lack of understanding. Moreover, media coverage of various

financial scandals has contributed to criticism of the Compensation Fund, criticism that is sometimes diametrically opposed, depending on whether it originates from consumers or intermediaries.

The consultation allowed a broad range of stakeholders to express their opinions on the various issues raised. The AMF analyzed all of the comments and proposals submitted to it.

Mindful of the need to improve the operation of the Compensation Fund, the AMF also made recommendations of its own. These recommendations are described and explained in detail in this report, each in connection with its related issue. They are also set out in Appendix 1.

APPENDIX 1

RECOMMENDATIONS

ISSUE 1

Role of compensation among measures intended to protect consumers of financial products and services

As regards this issue, in accordance with its Strategic Plan, the AMF makes the following recommendations:

- continue its consumer education efforts;
- continue to foster a “customer-centric approach” among its consumer assistance teams when dealing with consumers who are victims of fraud.

The AMF also recommends as follows:

- disseminate information to consumers about the various services the AMF offers them;
- develop fraud indicators, based on claims filed with the Fund, so as to support the AMF's education, fraud prevention and inspection efforts.

ISSUE 2

Accountability of consumers and market intermediaries

As regards this issue, the AMF recommends:

- regulatory amendments to establish a mechanism, like the one that exists within the professional orders governed by the *Professional Code* (R.S.Q., c. C-26), whereby a victim of fraud could see his claim for compensation rejected in the event of, in particular, false declaration, willing participation in the fraud, investments made to avoid tax, and money laundering.
- regulatory amendments intended to limit the amount of cash a consumer can give an intermediary in connection with a financial transaction;
- regulatory amendments so as to allow the AMF to evaluate the outside business activities of intermediaries (firms or other

entities), in particular by establishing disclosure requirements.

ISSUE 3

Fundamental objective of a compensation system

As regards this issue, the AMF makes the following recommendation:

- maintain the compensation ceiling at its current limit of \$200,000.

ISSUE 4

Approach with respect to consumer compensation

As regards this issue, the AMF makes the following recommendation:

- maintain the uniqueness of Québec's compensation scheme by retaining the Fund's current approach.

ISSUE 5

Responsibility for managing compensation mechanisms

As regards this issue, the AMF makes the following recommendations:

- maintain the system currently in place in Québec, namely, a compensation fund administered by the regulator;
- introduce regulatory amendments so that the rules for eligibility of claims are clearer for the general public.

ISSUE 6

Products, intermediaries and conduct covered by the Compensation Fund

As regards this issue, the AMF makes the following recommendations:

- maintain the Compensation Fund's current scope of application regarding the intermediaries covered;

- introduce legislative amendments with a view to applying the compensation mechanisms to any fraud, fraudulent tactic or embezzlement committed by an intermediary in the pursuit of his activities, regardless of the nature of the products offered, provided the intermediary is registered with the AMF and has contributed to the Compensation Fund;
- maintain the Compensation Fund's current scope of application regarding the conduct covered;
- ensure that unintentional gross negligence is covered under the liability insurance contracts of intermediaries.

ISSUE 7

Funding the Compensation Fund and cost containment measures

As regards this issue, the AMF makes the following recommendations:

- introduce legislative amendments to establish a 15% co-insurance as a cost containment measure;
- undertake work with a view to placing greater emphasis on the risk associated with each sector for purposes of determining the contribution rate and setting an appropriate capitalization target;
- undertake work aimed at identifying measures to improve the rate of recovery in subrogatory recourses.

APPENDIX 2

RESPONDENTS¹⁷

	Respondent's name	Group
1	Jules-É Blais	Industry - Mutual funds
2	Banque Nationale	Industry - Mutual funds
3	Fraser, Milner, Casgrain S.E.N.C.R.L.	Other
4	Mouvement des caisses Desjardins	Industry - Mutual funds
5	Chambre de l'assurance de dommages	SRO
6	Insurance Bureau of Canada	Industry - Insurance
7	Les services financiers Planifax Inc. and Mérci Services Financiers	Industry - Mutual funds
8	MICA Capital and MICA services financiers	Industry - Mutual funds
9	Quadrus Investment Services Ltd.	Industry - Mutual funds
10	Regroupement des cabinets de courtage d'assurance du Québec	Industry - Insurance
11	Association des banquiers canadiens	Industry - Mutual funds
12	Corporation des assureurs directs de dommages du Québec	Industry - Insurance
13	Marsh Canada Limited	Industry - Insurance
14	Chambre des notaires du Québec	Other
15	Conseil des fonds d'investissement du Québec	Industry - Mutual funds
16	Groupe Investors inc.	Industry - Mutual funds
17	Mouvement d'éducation et de défense des actionnaires (MÉDAC)	Consumers
18	Canadian Foundation for Advancement of Investor Rights (FAIR)	Consumers
19	M ^e Stanislas Bricka	Other
20	Groupe de recherche en finance appliquée (Grefa)	Other
21	Coalition pour la protection des investisseurs	Consumers
22	Nicole Laveau	Consumers
23	Fédération des chambres de commerce du Québec	Other
24	Investment Planning Counsel	Industry - Mutual funds
25	Canadian Investor Protection Fund	SRO
26	Portfolio Management Association of Canada	Industry - Mutual funds
27	Association canadienne des compagnies d'assurances de personnes inc.	Industry - Insurance
28	RBC Dominion Securities Inc. and RBC Global Asset Management Inc.	Industry - Mutual funds
29	Association canadienne du commerce des valeurs mobilières	SRO
30	Borden Ladner Gervais S.E.N.C.R.L., S.R.L. / LLP	Other
31	Michel Robert	Other
32	Mutual Fund Dealers Association of Canada	SRO
33	Chambre de la sécurité financière	SRO
34	Mackenzie Financial Corporation	Industry - Mutual funds

¹⁷ Briefs available on AMF website as submitted: <http://www.lautorite.gc.ca/en/previous-consultations-compensation-pro.html>