

Notice and Request for Comment regarding compensation of consumers of financial products and services

The Québec Minister of Finance and the Minister for Finance have asked the *Autorité des marchés financiers* (the “AMF”) to hold a consultation on the compensation of victims of financial crime.

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 and the way in which the *Fonds d’indemnisation des services financiers* (the “Financial Services Compensation Fund,” the “Compensation Fund” or the “Fund”) should operate.

An open discussion about the principles and orientations of the Compensation Fund is therefore essential to decide on the effectiveness of the existing compensation mechanisms and to improve them if necessary.

As part of this consultation, the AMF is seeking the input of citizens and industry members on the following issues:

Issue 1: Role of compensation among measures intended to protect consumers of financial products and services

In Québec, just as elsewhere in developed countries, the financial industry is subject to rigorous oversight to protect consumers of financial products and services (the “consumers”) by ensuring that their financial transactions take place in a reliable environment that inspires trust and that is conducive to making informed decisions. As part of this consultation, the AMF has published a [Reference Guide](#) on the protection measures currently in place.

Regardless of the quality of the regulatory framework, recent experience has shown that financial regulators cannot fully shield consumers against fraud, which is why Québec has set up a mechanism to compensate victims of fraud. Its purpose is to protect consumers against the consequences of conduct not covered by liability insurance and that violates the legal and regulatory framework governing the financial services industry.

Compensation is therefore the last defence within a scheme to protect consumers of financial products and services.

The purpose of this consultation is to allow the stakeholders to reflect on the balance between the measures in place to prevent fraud and those to compensate victims. There will necessarily be financial implications whether the decision is to bolster the fraud protection measures currently in place or to enhance the compensation plan.

Questions

1. *Based on your perception of the Québec system, should we rethink the balance between fraud prevention and victim compensation measures?*
2. *Since financial resources are limited, which solution should be given priority: bolstering fraud prevention measures or enhancing the compensation plan?*

Issue 2: Accountability of consumers and representatives¹

The presence of a compensation plan can affect consumer behaviour. In fact, the more extensive the compensation plan, the greater the likelihood that consumers will take greater risks since, ultimately, such risks would entail no financial consequences.

The corollary to lack of consumer accountability is lack of accountability among representatives. Broadening the compensation parameters could in fact encourage reckless behaviour by representatives secure in the knowledge that their clients will be compensated.

In this context, this consultation offers an opportunity to reflect on how the compensation mechanisms in Québec can ensure that both consumers and representatives remain accountable.

Questions

3. *Do consumers have a certain responsibility to avoid financial fraud?*
4. *How much importance should the compensation mechanisms in Québec place on the accountability of consumers and representatives?*
5. *Should a consumer who knowingly makes an illegal investment lose the right to be compensated in the event of fraud?*

Issue 3: Fundamental objective of a compensation system

Private insurance policies do not cover the risks associated with fraud mainly because of its intentional nature. Consumers therefore cannot take out insurance against theft of their financial portfolio or embezzlement of their insurance policies.

That is why mechanisms to overcome this lack of coverage were put in place. The amount of coverage offered by a compensation plan is directly tied to the objectives sought in providing compensation: total, partial or minimal compensation of damages.

The current maximum compensation of \$200,000 in Québec is a reflection of this fundamental objective.

Questions

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

Issue 4: Approach with respect to consumer compensation

A review of various compensation systems reveals two broad approaches. In Canada, with the exception of Québec, funds have been 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. Insolvency funds are used only when all of the firm's resources have been exhausted.

¹ The term "representative" is used to simplify the text and means both natural persons and companies authorized to carry out activities covered by *An Act respecting the distribution of financial products and services* or the *Securities Act*.

Québec uses a different approach. The Compensation Fund compensates claimants regardless of the financial situation of the firm at fault. If the eligibility requirements are met, the claimant is entitled to an indemnity. The process is similar to a claim filed with an insurer. After it compensates the claimant, the AMF institutes a subrogatory recourse against all entities considered at fault.

With this approach, consumers benefit from a simplified claim system at no cost to them. There are, however, significant costs to the representatives who contribute to its funding.

This consultation is an opportunity to reflect on the different approach used in Québec with a view to harmonizing it with the practices observed in the rest of Canada.

Questions

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?*
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?*

Issue 5: Responsibility for managing mechanisms intended to compensate victims of financial crime

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 strictly apply the fund's rules when deciding on the payment of indemnities.

The Compensation Fund is currently a separate patrimony constituted within the AMF, which is responsible for managing the Fund and ruling on claim eligibility.

The AMF is well placed to take on this role mainly because of its knowledge of the market and its investigative functions. Generally, consumers benefit from this situation if only because it reduces the number of administrative steps involved.

However, the administration of a compensation fund is not necessarily compatible with the oversight role of a regulatory agency and may raise governance issues. If the AMF were to mismanage the Fund, it could lead to a conflict of interest, either real or apparent.

There are mechanisms that could minimize these risks. This consultation is an opportunity to examine these alternative mechanisms and their potential impact on the compensation system.

Questions

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

Issue 6: Products, representatives and conduct covered by the Compensation Fund

In Québec, the Fund will offer compensation under the following conditions:

- (1) The financial products in question are in keeping with those that the representative was legally authorized to offer within the scope of his certificate.
- (2) The conduct involves representatives who contribute to the Compensation Fund, i.e. representatives governed by *An Act respecting the distribution of financial product and services* or by mutual fund or scholarship plan representatives governed by the *Securities Act*. Investment dealers and fund managers are not covered.
- (3) The alleged misconduct constitutes fraud, fraudulent tactics or embezzlement, in short, willful misconduct. Failure to fulfill obligations, errors, poor advice or negligence are covered by professional liability insurance that representatives are required to purchase.

These limits to Fund coverage are often mentioned as the cause of consumer dissatisfaction. However, expanding coverage would have implications at various levels. This consultation is therefore an opportunity to delve into the conditions for Fund compensation and whether to change them.

Questions

14. *Should the conduct covered include actions outside the limits permitted by the representative'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?*
15. *Should the Compensation Fund coverage be extended to all entities registered with the AMF, including investment dealers and fund managers?*
16. *Should the Compensation Fund coverage be limited to conduct currently covered, i.e. fraud, fraudulent tactics and embezzlement?*
17. *Should we instead expand the coverage to include gross negligence, errors, omissions and any other failure?*
18. *What would the implications be? For example, would there be a risk of overlapping with other compensation programs or professional liability plans?*

Issue 7: Funding the Compensation Fund and cost containment measures

The Compensation Fund does not require any direct contribution from consumers. It currently has three sources of funding: dues paid by firms of the representatives covered, amounts recovered through subrogatory recourses initiated by the AMF, and interest income. Dues paid by the industry are intended to cover the Fund's current needs. There is no reserve.

Dues are adjusted according to the Fund's financial needs. However, an overly high or poorly designed rate structure could have adverse effects such as a less attractive and less diversified offering of financial products, a lower long-term return for Québec investors and a less dynamic Québec financial industry.

In this context, various measures could be explored to reduce the financial pressure on the Compensation Fund such as a deductible, co-insurance, bonding and a reduction in the indemnity ceiling.

This consultation is an opportunity to reflect on the balance between the extent of the Fund's coverage, its costs and measures to contain them. There are also measures to limit the variability of contribution rates in the event of a major fraud.

Questions

19. *Considering the extent of the Fund coverage, its costs and economic consequences, as well as its potential effect on the conduct of consumers and representatives, 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?*
20. *Should we implement cost containment measures and increase the accountability of consumers and representatives? 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?*
21. *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?*

Comments and proposals

As part of this consultation, the AMF is receptive to any proposal, submitted in writing, with clear suggestions on how to modify the Québec compensation system.

The AMF may ask to meet with the authors of the briefs to obtain clarifications on the comments and proposals submitted.

Please note that, unless otherwise indicated, the comments received will be posted on the AMF's website.

Individuals and organizations interested in participating in this public consultation must submit their observations in writing, preferably electronically, no later than **"February 7, 2012"** to:

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Additional information

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