FAIR

Canadian Foundation *for* Advancement *of* Investor Rights
Fondation canadienne *pour* l'avancement *des* droits *des* investisseurs

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A REPORT ON

A DECADE OF FINANCIAL SCANDALS

FAIR Canada Calls for a National Action Plan to Tackle Investment Fraud

February 2011

Executive Summary

Financial Fraud a Major Problem

1. For years, there has been a widely held belief that financial fraud is rampant in Canada. One in ten Canadians say that they have actually invested money in what turned out to be a fraudulent scheme. The number of fraud victims appears to be on the rise as does the amount invested.

2. FAIR Canada decided to study a select number of financial frauds to see if there were lessons to be learned about: (1) how to improve prevention, detection and prosecution of financial fraud and (2) how to better protect investors and compensate victims of fraud.

3. FAIR Canada limited its study to fifteen cases (most of which were high profile cases involving a significant amount of money and large number of victims) from across the country (including BC, Alberta, Ontario and Quebec). The review yielded some interesting and surprising results. However, the study was not a comprehensive empirical study of investment fraud in Canada. The findings should be seen in light of their being limited to these fifteen cases.

4. Preparing a report on combating investment fraud through better prevention, earlier detection and more effective prosecution and how to better compensate victims of investment fraud is an enormous undertaking requiring significant resources and access to information. FAIR Canada has limited resources and (although we have consulted with stakeholders) limited access to information. We welcome feedback from all stakeholders (and in particular, the governments, securities regulators, SROs, and others mentioned in this report), and may issue an amended version of this report with the benefit of such feedback.

Complex and Fragmented System Not Effective

5. The Canadian securities regulatory system is complex and fragmented. There are thirteen provincial and territorial securities regulators and two national SROs. In addition, there are many other provincial and federal regulators involved in regulating financial institutions and the financial products they sell. For example, insurance regulators regulate segregated funds, which are essentially a form of mutual fund with an insurance component added.

6. When it comes to the investigation and prosecution of financial fraud, the complexity and fragmentation of the system in Canada is far worse. In addition to the regulators listed above, local and provincial police, as well as the RCMP and IMET are involved in investigations. In addition, numerous provincial and territorial Attorneys General can be involved in prosecutions.

7. With this bewildering array of regulators, investigation agencies and prosecutors, no one agency has ultimate responsibility for combating investment fraud. If a victim of fraud

contacts the police or regulators, more often than not they will be referred to another agency.

Findings of Review of Cases

8. Findings from the fifteen cases reviewed by FAIR Canada included the following:

- Approximately 78% of the losses in the fifteen cases involved firms or individuals registered with regulators.
- Approximately 17% of the losses involved registered persons were with firms that were members of an SRO. Members of the two SROs are backed by compensation funds in the event of firm insolvency.
- Some 61% of the losses were with registered firms directly regulated by a securities regulator but that were not members of an SRO. These firms are not backed by a compensation fund. Investors with non SRO registrants sustained higher losses and were not likely to recover most of their money.
- Approximately 22% of the losses were a result of dealing with persons who were not registered with a securities regulator and investors often lost all of their money.
- Even though there are two compensation funds (CIPF and IPF) that compensate investors in event of insolvency of investment firms and mutual fund dealers, the funds only compensated 2% of the financial losses because most of the investment scams involved firms that were not members of the compensation fund and related SRO and of the five that were, three fell outside the scope of coverage. The registrants that appear to be the highest risk to retail investors are not members of an SRO and have no compensation fund.

RECOMMENDATIONS

9. In summary, our recommendations address fraud prevention, early detection of fraud, enforcement and victim compensation:

1. **Fraud prevention** – Government and regulators should launch a major campaign to educate consumers on avoiding financial fraud and securities regulators should provide a comprehensive national database to check registration, disciplinary history, SRO membership etc. We also suggest that: (a) firms be made responsible for misconduct by rogue advisors even when they sell non-firm products, (b) registrants have a professional duty to report misconduct by other registrants, and (c) financial incentives be considered to encourage reporting of fraud to regulators.

2. **Earlier detection of fraud** – We recommend that regulators have dedicated resources to detect fraud. Regulators should reform "exempt offerings" and "accredited investor" exemptions in securities laws and should audit high-risk exempt offer filings.

3. **Prosecution** – Canada needs a new expert national agency under the Attorney General of Canada dedicated to combating financial fraud.

4. **Compensation** – FAIR Canada recommends that all registrants that deal with the public be required to be members of an SRO with an existing compensation fund. Further, regulators should have consistent statutory powers to order compensation for victims of financial fraud and should have a clear mandate to seek compensation for victims of fraud.

Recommendations for Combating Financial Fraud and Compensating Victims

1. Fraud Prevention

FAIR Canada recommends that:

- Government, regulators and SROs launch a major public education campaign to educate Canadians about avoiding financial scams.
- Regulators provide a comprehensive, plain language, "one stop" national system for the public to check registration status, background information (including proficiency and disciplinary record) and SRO membership for firms and individuals advisors.
- Registered firms be made financially responsible for compensating clients that are victimized by a rogue advisor that they employ.
- Regulators consider introducing rules that require all registrants to report potential serious misconduct by another registered person.
- Financial incentives be considered for members of the public who report potential financial fraud (whether the potential fraudster is a registrant or not) to regulators or police.

2. Earlier Detection of Financial Fraud

FAIR Canada recommends that:

- Securities regulators devote dedicated resources to financial fraud detection and engage in more proactive measures to detect and prevent fraud.
- Securities regulators reform the "exempt offerings" and "accredited investor" exemptions to ensure that they are not used to sell investments to unsophisticated consumers.
- Regulators audit the veracity of exempt offering filings based on a risk assessment.

3. Enforcement

FAIR Canada recommends that:

- The Federal and Provincial Attorneys General, regulators and police convene a summit to discuss how Canada can do a better job of preventing, detecting and prosecuting investment fraud.

- The Federal Government consider the creation of a national agency under the Attorney General of Canada staffed by experts to specifically target investment and other financial fraud.

4. <u>Better Compensation for Victims</u>

FAIR Canada recommends that:

- Existing provincial regulators mandate that all registrants be members of an existing SRO backed by an existing compensation fund.

- Provincial regulators, SROs and compensation funds convene a summit to develop a strategy to ensure that compensation funds cover fraud leading to insolvency of all registrants, and to address gaps in compensation fund coverage.

- Securities regulators be given consistent statutory powers to order compensation for victims of financial scams, and a clear mandate to seek compensation for victims.

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1. Review of Securities Scandals

1.1. Background to FAIR Canada Review - Over the past decade, Canadians have suffered significant losses as a result of financial frauds. In the past year, financial fraud and other financial market misconduct affecting Canadians, appear in the media virtually on a daily basis. Canada appears to have a serious problem with financial fraud and government, regulators, police and prosecutors do not seem to be effective at prevention, detection and prosecution. FAIR Canada has examined a subset of fifteen securities- or investment-related scandals that occurred in Canada over the last decade. These losses were caused by a variety of misdeeds, including Ponzi schemes, the misappropriation of assets and the mismanagement of books and records. See Appendix A for the complete list of scandals FAIR Canada reviewed.

1.1.1. The purpose of our review was to identify in a non-empirical or exhaustive manner, where, how and to what extent losses were suffered by Canadian investors in securities scams, and to evaluate the effectiveness of the regulatory system in detecting frauds, compensating the victims of fraud and sanctioning the perpetrators of the frauds. Most importantly, we wanted to determine whether the sample of selected frauds provide lessons about how Canada can: (a) improve the prevention, detection and prosecution of capital market fraud, and (b) better protect and compensate Canadians who are the victims of securities fraud.

1.2. Financial Crimes Devastate Individuals - As of July 2009, an estimated 1.3 million Canadians have been victims of fraud at some point during their lives.[1] In many cases, investors lose a significant part of or their entire life savings. The impact on their lives is devastating and irreversible. These crimes impact the financial, emotional, psychological and physical health of the victims and seed doubts about the security and fairness of our financial system.[2]

1.3. Financial Frauds Undermine Investor Confidence - Half of Canadian fraud victims say that fraud caused them not to trust "…the way investments are run and regulated…"[3]. Victims of fraud report high incidences of stress, anger, depression, loss and isolation.[4] Nine in ten Canadians agree that "[t]he impact of investment fraud can be just as serious as the impact of crimes like robbery and assault."[5] Half of Canadians do not believe that authorities treat fraud as seriously as other crimes, and a majority

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[1] See the Canadian Securities Administrators Investor Education Committee's *CSA Investor Index 2009*, found at <http://www.securities-administrators.ca/uploadedFiles/General/pdfs/CSA%20Investor%20Index%202009%20Final_EN.pdf?n=6519>.

[2] Jean St-Gelais, CSA Chair and President and CEO of the Autorité des marchés financiers, noted in the 2009 CSA Enforcement Report, found at <http://www.securities-administrators.ca/uploadedFiles/General/pdfs/CSAReportENG09%5bFA%5d.pdf>.

[3] Canadian Securities Administrators Investor Education Committee, *2007 CSA Investor Study: Understanding the Social Impact of Investment Fraud*, found at <http://www.msc.gov.mb.ca/about_msc/2007_csa_invest_exec.pdf>.

[4] Michael Kempa, *Combating White Collar Crime in Canada: Serving Victim Needs and Market Integrity*, online: <http://www.policecouncil.ca/reports/Kempa_Combating%20White%20Collar%20Crime%20in%20Canada_Kempa.pdf>.

[5] Canadian Securities Administrators Investor Education Committee, *2007 CSA Investor Study: Understanding the Social Impact of Investment Fraud*, found at <http://www.msc.gov.mb.ca/about_msc/2007_csa_invest_exec.pdf>.

think that people who defraud others tend to get away with it and those who get caught receive a light sentence at most.[6]

1.4. **Fragmented Regulatory System** - The Canadian regulatory framework for regulation of investments is complex and fragmented. First, there are thirteen provincial and territorial statutory securities regulators and two national self regulatory organizations. In addition, there are many other provincial[7] and national regulators that are involved in regulating financial institutions and investment products. When it comes to enforcement, the complexity and fragmentation gets much worse, as it includes provincial crown prosecutors and local and provincial police forces as well as the RCMP and its Integrated Market Enforcement Teams ("**IMET**"s) which were set up to combat commercial crime. The fragmented system, the combined delays in the justice system and difficulty in tracing assets make these cases complex and time-consuming, which results in most cases taking years to resolve.

1.5. **Who is Responsible?** - With this bewildering array of government, regulators and police, it appears that no one has ultimate responsibility for prevention, detection and prosecution of investment frauds and scams. An investor who has lost $50,000 in an investment scam may start by calling the local police who may refer the victim to the provincial police, a commercial crime unit, the RCMP or IMET or a provincial securities commission. The victim may contact each of these agencies only to find that none of them wants to assume responsibility for investigating and prosecuting the investment scam. Even if some agency is willing to investigate, the investigation may take many years and the crown prosecutor may decide not to prosecute due to lack of resources.

1.6. **Role and Power of Regulators** - Where a securities regulator undertakes an investigation of an investment scam, this may be of little benefit to the victims of the fraud as the regulator's priority will be enforcement rather than victim compensation. Regulators may impose administrative sanctions such as removing trading privileges or imposing fines (which are generally never collected). Such sanctions represent a minor wrist slap for a serious crime.

1.6.1. Even where the regulator prioritizes compensation it may lack the necessary statutory power to compensate the victims. In its Final Report and Recommendations, the Expert Panel on Securities Regulation expressed concern about the degree of variation in financial redress provided by securities commissions across Canada.[8] As we note later in this report, some provincial commissions have the power to order compensation up to certain limits, while others do not. The Panel noted Québec's process (where compensation can be paid directly to victims) to be a best practice,

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6 *Ibid*.

7 Throughout this report, the terms 'provincial' and 'province' are used to denote both the provinces and territories of Canada.

8 Expert Panel on Securities Regulation, *Final Report and Recommendations, January 2009*, online: <http://www.expertpanel.ca/eng/documents/Expert_Panel_Final_Report_And_Recommendations.pdf> at page 35.

and recommended that a national regulator be vested with the power to award compensation.[9]

1.7. **Proposed National Commission** - Under the proposed Canadian securities legislation[10], the Canadian Securities Regulatory Authority will have the power to designate an organization or entity to be a national compensation fund. However, we understand that this is only intended to recognize the existing compensation funds and that it will not address any of the gaps currently existing for victims of securities fraud. The proposed national regulator would not be granted the specific power to order restitution or to award compensation to wronged investors. Consistent with the recommendations outlined in the Expert Panel Report[11], FAIR Canada supports the recommendation for a securities regulator with the power to order compensation. At a minimum, compensation powers across all provincial and territorial securities regulators should be clear and consistent.

1.8. **Compensation Fund Gaps** - Some registered firms are backed by compensation funds that compensate clients in the event of insolvency of the firm (major frauds involving senior management generally lead to insolvency) but many other registered firms are not. If a government regulated firm becomes insolvent, it is unlikely that it is a member of an SRO backed by a compensation fund. Even where the regulated firm is backed by a compensation fund, some frauds by the firms or individual advisors are not covered by compensation funds.

1.9. **Compensation Funds in Canada** - Unfortunately for Canadian investors, there is no single comprehensive, national compensation fund in Canada that covers investment fraud-related loss, even if those losses relate to misdeeds committed by registered firms or individuals.

1.10. **Canadian Investor Protection Fund** - The Canadian Investor Protection Fund ("**CIPF**") is a national, non-statutory private sector fund established by the securities industry. CIPF provides coverage in the event of insolvency of IIROC member firms. The coverage is automatic when an investor opens an account with an investment dealer who is a member of CIPF. The Fund does not cover consumer losses caused by the changing market values of securities, unsuitable investments, or the default of an issuer of securities that is not a member of IIROC. CIPF covers up to $1 million in aggregated losses per investor[12]. As of December 31, 2009 the resources available to pay customers' claims totalled $559 million; this is made up of a General Fund balance of $359 million, two lines of credit totaling $100 million, and an insurance policy that provides for recovery of amounts paid in excess of $100 million up to a limit of $100 million per year.

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[9] *Ibid*.

[10] Proposed Canadian Securities Act, found at <http://www.fin.gc.ca/drleg-apl/csa-lvm-eng.htm>.

[11] Expert Panel on Securities Regulation, *Final Report and Recommendations, January 2009*, online: <http://www.expertpanel.ca/eng/documents/Expert_Panel_Final_Report_And_Recommendations.pdf>.

[12] CIPF covers up to $1 million of losses in a "general" account (e.g. combination of cash accounts, margin accounts, short sale accounts and the share of joint account), plus an additional $1 million for each "separate" account (e.g. testamentary trusts, *inter-vivos* trusts, RESPs and RRSPs).

1.11. Investor Protection Corporation - The Investor Protection Corporation ("**IPC**") is a national private sector fund (excluding accounts held in Québec[13]) which provides coverage to customers who incur losses of their assets as a result of the insolvency of MFDA member firms. Losses resulting from the changing market values of securities, unsuitable investments, or the default of an issuer of securities are not covered by IPC. Coverage is available for up to $1 million for each of a customer's general and separate accounts[14]. Claims must be filed within 180 days of the date of insolvency. As at June 30, 2010, the balance in the fund stood at $27.8 million. In addition, the IPC has a credit facility with a maximum limit of $30 million.

1.12. Fonds d'indemnisation des services financiers[15]

The Fonds d'indemnisation des services financiers (the "Fund") covers investor losses resulting from "fraud, fraudulent tactics or embezzlement for which a firm, an independent representative or an independent partnership is responsible" and which were committed in the course of the distribution of financial products and services. Losses resulting from fraud due to the mismanagement of the mutual funds themselves are not covered. Eligibility for coverage is determined on a case by case basis by the AMF. The Fund's coverage is limited to $200,000 per claim. As at March 31, 2010, the Fund had a negative balance of $20 million.

1.13. Current Compensation System - The current system for compensation in Canada is complex and full of gaps. See the description in section 5 of compensation options available to Canadian investors. Most importantly, the current system does not adequately provide victims with what they most want and need – the timely return of their lost funds. Canadian compensation funds only applied in one of the fifteen cases reviewed even though the majority of cases involved registered firms and individuals. The compensation funds compensated only a small number of victims, and only 2% of the Total Loss. The 2009 CSA Investor Index noted that 70% of fraud victims did not recover any of their financial losses.[16]

1.14. Registration - In Canada, some form of provincial registration[17] or licensing is required when an individual or firm is engaged in the business of trading or advising in securities or in the sale of life insurance, which includes securities-like instruments such as segregated funds and variable life contracts. Throughout this document, we refer to firms or individuals licensed by securities regulators as "registrants". In most provinces, insurance and securities businesses are administered by different agencies. Even where life insurance and securities administration is consolidated (e.g. Québec and Saskatchewan), the businesses are governed by different sets of laws and policies. Yet most individuals dually licensed under both regimes deal with the public simply as financial consultants or financial planners, selling indistinguishable instruments (e.g.

[13] The MFDA is not recognized as an SRO in Quebec, and, as a result, clients of MFDA members operating in Québec do not qualify for IPC compensation.

[14] Most customers will have two "accounts" for coverage purposes, the aggregate of their trading accounts (general account) and the aggregate of their registered retirement accounts, such as RRSPs and RIFs (separate account).

[15] See http://www.lautorite.qc.ca/clientele/consommateur/demande-indemnisation.en.html.

segregated funds and mutual funds) leaving their clients oblivious to the complexity and fine distinctions underlying the mechanisms that exist to protect them from fraud.

1.15. Self-Regulatory Organizations - Registrants that conduct a securities business which allows them to deal with all types of securities and investors must be members of an industry-funded self regulatory organization ("**SRO**"). SROs can be formally recognised by provincial securities regulators and are permitted to substitute their own rules and guidelines for prescribed rules. Often the SROs impose higher standards including compliance standards. SROs are expected to supervise their members for compliance with these requirements and are subject to regulatory audit. The two securities industry SROs in Canada are the Investment Industry Regulatory Organization of Canada ("**IIROC**") and the Mutual Fund Dealers Association ("**MFDA**"). The MFDA is recognised as an SRO in all provinces except Québec. IIROC district counsels are recognised as SROs in each province. The Chambre de la sécurité financière ("**CSF**") is an SRO recognized in the province of Quebec by the AMF. The CSF oversees individual advisors who sell mutual funds, scholarship plans, and certain insurance products.

1.16. Regulation by Historical Accident - Protection of consumers from financial abuse is fragmented along historical "product" lines. Yet this does not reflect the converged business model of most of the individuals and firms dealing with typical investors. Insurance counsels in some provinces (e.g. B.C. and Alberta) act as SROs for individuals selling life insurance, other provinces (e.g. Ontario) regulate directly. The sale of mortgages, interests in real estate and the mortgage brokerage business is again regulated separately in all provinces, yet individuals who are licensed in non-SRO categories to sell securities or to sell life insurance can conduct this business as well.

1.17. Compensation Funds Tied to SRO Membership - Members of either of Canada's national[18] securities SROs are backed by compensation funds that cover firm insolvencies affecting client assets. Firms registered as Exempt Market Dealers, ("**EMDs**") and Portfolio Managers ("**PMs**") are not SRO members and no compensation fund exists to protect client assets held in the firm on insolvency. All registrants are now required to obtain fidelity insurance against fraud and theft, including EMDs as of September 2009.

1.18. Checking Registration Status in Canada - In order to protect investors from frauds and scams, securities regulators recommend that investors check whether a firm or individual is registered, and also verify the disciplinary history of individuals.

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[16] Canadian Securities Administrators Investor Education Committee, *CSA Investor Index 2009*, online: <http://www.securities-administrators.ca/uploadedFiles/General/pdfs/CSA%20Investor%20Index%202009%20Final_EN.pdf?n=6519>.

[17] When we refer to 'registration', we use the term broadly to refer to individuals and firms being registered under one or more of the provincial securities acts. We recognize that, in a number of provinces, provincial securities regulators have delegated the authority to register individuals and/or firms to IIROC. They are nevertheless registrants in prescribed categories under provincial securities laws. In our study, we use the term 'registration' to refer to all such firms or individuals, regardless of whether administrative authority has been delegated to IIROC.

[18] As noted above, although we acknowledge that the MFDA is not recognized as an SRO in the province in Québec, for purposes of this report, we refer to both IIROC and MFDA as *national* SROs in Canada.

Registration information for SRO and non-SRO firms and individuals is entered into a searchable national database, the National Registration Database ("**NRD"**) under the joint auspices of the umbrella organization that represents the provincial securities regulators, the Canadian Securities Administrators **("CSA").** Current information as to registration status, registration category, scope of activities and any terms and conditions can searched for firms and individuals for all provinces except Québec and Ontario from the NRD website, and there is a simple link to the Ontario Securities Commission's registration database. Québec must be searched directly on the AMF website.

1.19. **Checking Registration is Difficult for Investors** - However, there are limitations for anyone unfamiliar with the technicalities of the registration system who tries to search the database. The investor needs to know the registered name of the firm, although this may not be the business name the investor knows. For example, a search for an adviser at "CIBC Wood Gundy" draws a blank. The investor needs to know to search "CIBC World Markets". Investors may not understand the significance of a listed registration category (e.g. that "investment dealer" means an IIROC member) or what a condition attached to registration means. No registration history is shown for firms that merge or registrants that move from firm to firm. Disciplinary history is not shown on the national registration system. Information on disciplinary action is only available by searching SRO websites for SRO members, and for non-SRO members, wading through enforcement documents on individual regulators' websites (although even this may not reveal disciplinary history).

1.20. **Comprehensive National System Recommended** - The complexity of the regulatory regime and the fact that multiple sources must be consulted can make background checks, or even determining if someone is registered or not, a difficult and confusing exercise for a retail investor. Even when investors are aware that they should "check" the registration information of a firm or individual, the system of registration currently in place in Canada is so complex that it would be difficult for most investors to understand exactly what and where they should check or to get the basic information they need.

1.20.1. **To remedy this problem, FAIR Canada recommends that Canadian regulators provide an informative, comprehensive, "one-stop" national system for investors to check registration and background information (including proficiency and disciplinary history) and SRO membership for all firms registered with securities regulators and SROs and to identify non-securities licenses for individuals licensed under different regimes with different sponsoring firms. This system should include plain language explanations of the information provided and be searchable under business names as well as proper legal names.**

1.21. **Cases Reviewed Not Comprehensive** - The cases reviewed by FAIR Canada included schemes through which investors lost money by investing in securities that were either non-existent, mismanaged or misappropriated to finance the lifestyles of the principals of a firm. A number of the cases reviewed were "Ponzi"-style schemes,

where a firm or advisor used the investments of later investors to fund promised returns to earlier investors. Examples of Ponzi-style schemes include the Earl Jones scandal in Québec, the Manna case in British Columbia, and Weizhen Tang in Ontario. Our review was not exhaustive of financial scams over the past decade, and did not include other investment frauds and scams, such as "pump and dump" schemes, and listed company fraud (including accounting fraud). Throughout our report, we refer to the fifteen cases reviewed as "scandals" or "frauds".[19]

1.21.1. The fifteen cases selected by FAIR Canada were determined to have had a significant impact on Canadian investors based on either the total dollar amount lost and/or the number of investors affected and include scandals from several provinces. Information on these cases was gathered from a variety of sources, including court documents, securities regulators' publications (including records of hearings and decisions), trustees' reports, bail reports and media articles.

1.21.2. Collecting up-to-date information for this report was a challenging exercise, given the absence of a central national authority or body responsible for investigating and prosecuting financial fraud. As noted above, the responsibility currently falls to thirteen provincial and territorial securities regulators, two SROs, the Royal Canadian Mounted Police (including IMET), provincial and local police, the Federal and Provincial Attorneys General.

[19] Throughout this report, when the term "fraud" is used, this does not mean that fraud-related charges have been laid, either pursuant to relevant securities legislation or the *Criminal Code* (Canada). We have used the term generically to describe the scandals reviewed by FAIR Canada, that included schemes through which investors lost money by investing in securities that were either non-existent, mismanaged, or misappropriated to finance the lifestyles of the principals of a firm or when there was criminal fraud, civil fraud, dealing in securities without being registered, serious misrepresentations and other misconduct. The one possible exception is Vantage, which appears to have involved mismanagement of books and records rather than investment fraud.

2. Analysis of Fifteen Investment Scandals

In the following sections, we describe the scandals reviewed in FAIR Canada's analysis, outline the characteristics of several groups that are particularly vulnerable to and affected by financial fraud, discuss the inadequacy of enforcement and recovery in Canada, and make recommendations to improve the existing system.

2.1. Investor Losses and Recovery - Canadian investors lost an estimated total of $1.9 billion in the fifteen financial scandals reviewed (we refer to this amount in our analysis as the "**Total Loss**"). Recovery for the victims was limited, and most of the recoveries that were made occurred long after the victims sustained the losses.

2.2. Main Findings – It is important to stress again that we have not undertaken an empirical study of all investment frauds by sellers of investments whether registered or not. While we believe the statistics are relevant and identify problems with the Canadian system, these numbers should not be interpreted as being indicative of investment scandals generally – they are limited to the fifteen cases that we selected. The statistics described below raise questions that we believe should prompt government and regulators (who have greater resources and access to information) to undertake a more comprehensive study.

- Approximately 22% of the Total Loss was linked to non-registered firms or individuals
- Approximately 78% of the Total Loss was linked to registered firms and/or individuals overseen by one or more securities regulators in Canada.
- Approximately only 17% of the Total Loss was linked to registered firms that were also SRO members: Essex, Farm Mutual, iForum, Thow, and Triglobal.
- Approximately 8% of the Total Loss was linked to IIROC members (Essex and iForum) and 16.1% of the Total Loss was linked to MFDA members (Farm Mutual, iForum, Thow, and Triglobal).
- Approximately 61% of the Total Loss was linked to firms that were not members of SROs and were directly regulated by the securities commissions.
- **Only 2% of the Total Loss was recovered through one of the two Canadian compensation funds.**

2.3. Victim Recovery - In total, investors recovered approximately $915 million, or 49.5% of the Total Loss in the fifteen cases studied. However, Portus skewed the results and these figures do not give a real picture of limited recovery of losses.[20] Recovery by

[20] While Portus was a major scandal that involved negligence, non-compliance, regulatory inaction, financial mismanagement and misrepresentations to investors, it was distinguishable in the sense that investor funds were not all misappropriated or paid out in a Ponzi scheme. Rather, when a receiver was ordered in, most investor funds were found to be tied up in long-

Portus investors through private settlements totalled 66.9% of all funds recovered in the cases we reviewed. Excluding Portus from the results, investors in the fourteen other cases recovered approximately 14% of their combined loss. In only one of the fifteen cases reviewed were investors eligible for compensation by Canadian compensation funds. Two others were compensated by provincial compensation funds, one of which has since been phased out.

2.3.1. Investors' recovery in the fifteen cases reviewed (including Portus) can be broken down as follows:

Recovery (in millions)	Recovery (as % of Total Loss)	Source of Recovery
$39.2	2.12%	Compensation Fund
$4.3	0.23%	Disgorgement
$169.4	9.16%	Receiver
$690.1	37.3%	Settlement/Class Action
$12.0	0.65%	Fees Repaid
$915.0	**49.45%**	**Total**

2.3.2. Investors' recovery in the fourteen cases reviewed (excluding Portus) can be broken down as follows:

Recovery (in millions)	Recovery (as % of Total Loss)	Source of Recovery
$39.2	3.7%	Compensation Fund
$4.3	0.41%	Disgorgement
$26.0	2.46%	Recovery by Receiver
$78.2	7.4%	Settlement/Class Action
$0	0%	Repaid Fees
$147.7	**13.98%**	**Total**

2.4. Frauds involving Registered Firms and/or Individuals - Surprisingly, FAIR Canada's research shows that approximately 78% of the Total Loss suffered by investors in the fifteen cases reviewed can be traced back to registered firms and/or individuals. However, only some 17% of the Total Loss can be traced back to registered firms that were also members of one of the two national SROs (IIROC and the MFDA). The scandals involving non-SRO registered firms or individual advisors also affected the largest number of investors.

term deposits with major financial institutions rather than invested in market-neutral hedge funds as promised, so could not be liquidated quickly or cheaply. The bulk of investor claims to funds in long-term deposits were bought by Manulife at full value in anticipation of an ultimate good recovery. Commissions and finders' fees were returned to retail clients by IIROC and MFDA member distributors. Since investors did not suffer losses in the sense of the other cases reviewed, we have excluded Portus figures from the Total Loss computation.

2.5. Registered Firm, but Non-Registered Individual - Approximately 5% of the Total Loss was attributable to one case of investments with a non-registered advisor at an AMF-registered firm. None of the loss resulting from the case was recovered by investors.

- ***Triglobal*** is a Québec case where, although the firm itself was operating as a mutual fund dealer and was registered with the AMF, the company's executives were not registered. Both principals fled Canada, which resulted in a total of $86.3 million unrecoverable loss for 250 investors.

2.6. Registered Firm and Registered Individual - As noted above, a surprising 78% of the Total Loss can be traced back to registered firms or individuals. Over 73% of the Total Loss is linked with both a registered firm and a registered individual.

- In 1999 assets were frozen and it was uncovered that Ontario investment dealer ***Essex*** and its related company Nelbar had defrauded 143 investors of $12.8 million. Essex was registered as an investment dealer with the OSC, and was a member of the IDA at the time of the insolvency. Its principals, Allen and Moriarty, were registered with the OSC. Nelbar was not registered.

- Between approximately June 2003 and April 2007, ***Farm Mutual*** lost $50 million of its 511 investors' funds. The firm was registered with the OSC as a mutual fund dealer and limited market dealer.

- ***iForum*** involved two registered companies affiliated with Mount Real. One of the entities was a member of the IDA and the other was a member of the MFDA. 1,600 investors in this case lost $130 million.

- ***Norbourg***'s principal Vincent Lacroix was registered with the AMF as a securities advisor, and Norbourg was also registered with the AMF. Approximately 9,200 investors in Québec lost a total of $115 million.

- ***Norshield***, a Montreal-based manager and advisor to hedge funds, was registered with both the OSC (as investment counsel and portfolio manager) and the AMF (as an advisor with unrestricted practice). The scandal involved over 2,000 investors and cost investors $159 million in losses.

- ***Portus*** was registered in all provinces except Québec as an investment counsel, portfolio manager and limited market dealer. Losses to its 26,000 investors were estimated to be $793.9 million, although most of the losses were recovered though a combination of legal settlements, recovery by the receiver and refund of commissions.

- The ***Weizhen Tang*** operation was in place from 2006 to 2009, in which 200 Chinese Canadian investors in Ontario lost $60 million to an improperly

registered individual (Tang), who is alleged to have been running a Ponzi scheme.

- Between January 2003 and May 2005, dozens of investors in British Columbia and Alberta lost $32 million in the ***Thow*** case. Thow was registered with the BCSC as a mutual fund salesperson, and Berkshire was registered in British Columbia and Ontario and was a member of the MFDA.

- In 1998, a $1.8 million shortfall was discovered in the accounts of the British Columbia Securities Commission-registered mutual fund dealer ***Vantage*** Securities Inc.

2.7. **Cases of Firms and Individuals with No Registration** - Less than half (five out of fifteen) of the financial scandals that we examined, involved firms and individuals not registered with securities regulators. About 22% of the Total Loss can be traced back to non-registered individuals and firms. The majority of these 'no-registration' scams were affinity frauds and Ponzi schemes, and the losses to investors were all significant (averaging between $20,000 and $500,000 per investor).

- The following cases involved individuals and firms with no registration:

    - ***Brost, Sorenson et al.*** scheme in Alberta, operated between 1999 and 2005, where investors lost up to $400 million,

    - uncovered in 2009, the ***Earl Jones*** case in Québec involved 158 elderly Anglophone investors who lost over $50 million,

    - the 2004-2005 ***Fulcrum*** case, which involved $3.4 million in investor losses,

    - 1999-2003 ***Lech*** case, where Lech was charged with 88 counts of fraud, and hundreds of investors lost $100 million, and

    - in British Columbia, the fraud committed by four principals of ***Manna*** between 2005 and 2007, which totalled up to $16 million in investor losses.

2.8. **SRO Member Losses** - Five of the fifteen cases reviewed involved firms or individuals that were SRO members at the time of the relevant scandal. Investor losses in these cases totalled approximately 17% of the Total Loss. In each of the cases, the firm was registered with a securities commission and in all but one, the associated individual was also registered with a securities commission. These cases are all summarized above (***Essex, Farm Mutual***, ***iForum***, ***Thow***, *and* ***Triglobal***).

2.8.1. While statistics are surprisingly hard to come by, it is our belief that registrants that are also SRO members represent the great majority of the securities business in

Canada. Included in SRO member firms are the securities subsidiaries of the banks and the major mutual fund management companies.

2.9. **Non-SRO Registrant Losses** - As noted above, approximately 78% of the Total Loss was attributable to registered firms or individuals. However, only some 17% of the Total Loss involved registered firms or individuals who were also subject to the supervision of an SRO. It would therefore appear that registrants that are directly regulated by a provincial securities commission (but not an SRO) represent a much greater risk of investment fraud losses by investors than registrants that are also SRO members. In addition, these higher risk registrants are not backed by a compensation fraud.

2.9.1. This means we may have a perverse arrangement in Canada: low risk registrants are backed by a compensation fund that reimburses investors in the event of a fraud leading to the insolvency of the firm. On the other hand, the high-risk registrants may not be supervised as effectively and are not backed by a compensation fund. In the event of fraud leading to insolvency, retail investor clients of these firms are unlikely to see the return of much of their investments, and in many cases there is no recovery for investors.

2.9.2. The current situation gives rise to many questions for which there are no clear answers.

- Why do registrants that are directly regulated by a statutory regulator appear to be more likely to be a source of investment fraud and insolvency? Do securities commissions lack resources or are they simply saddled with most of the high-risk registrants?

- SROs and their members have a financial incentive to effectively supervise SRO member firms. If an SRO member becomes insolvent due to investment fraud the compensation fund established and funded by the SRO members is called to compensate investors. In the event of a larger fraud, the SRO members may be called on to contribute more money to their compensation fund. SRO members (and indirectly the SROs themselves) have “skin in the game” since they are penalized financially if another member becomes insolvent. Does having “skin in the game” influence the results?

- Registrants that are supervised by the securities commissions have no financial incentive to help police other registrants. Similarly, the securities commissions have no “skin in the game” since a fraud leading to insolvency of a registrant supervised by the commission does not affect them financially.

- Retail investors rely on the registration status of firms and individuals to protect them from fraud. As part of their fraud prevention strategy, regulators stress the importance of checking that a firm or individual is registered. In the circumstances, should retail investors have a right to expect that there is

effective supervision and recourse to a compensation fund in the event of fraud by a registered firm leading to its insolvency?

2.10. **Vulnerable Groups Targeted** - Although victims of investment scams can be diversely represented in terms of age, social, ethnic and cultural backgrounds, studies show that these scams often target the most vulnerable groups in society. According to the CSA's 2009 *Investor Index Study*[21], 38% of Canadians surveyed believe that they have been approached with a possible fraudulent investment. Of those, 50% experienced fraud while in a vulnerable situation. The CSA study provides several examples of investment-related vulnerability, including when a person: (a) loses a job and/or starts a new one, (b) experiences a financial windfall, (c) goes through a divorce or separation, or (d) is within 5 years of retirement. Vulnerable groups are often comprised of seniors, individuals saving for retirement and children's education, and representatives of faith-based, immigrant, ethnic and geographically smaller communities.

2.11. **The Elderly** - As noted above, one example of investment-related vulnerability can be age, particularly when an individual is close to retirement. In our analysis, the following cases involved this vulnerable group:

- ***Earl Jones*** defrauded 158 elderly Anglophone investors in Montreal, resulting in over $50 million in losses. He had built up trust with a number of the investors, based on his previous employment with Montreal Trust.

- Nearly 800 investors trusted their savings to the four officers operating ***Manna*** Corporation in British Columbia between 2005 and 2007. The scheme promised low risk and unrealistically high 125% annual returns. Many of the investors were older individuals close to retirement.

- ***Ian Thow***, the former vice-president of Berkshire Securities Inc. in British Columbia, promised "secure, high-yield investments" to a number of elderly investors, many of whom remortgaged their homes to invest. The loss to investors was $32 million.

2.12. **Affinity Frauds** - In "affinity frauds", members of identifiable groups who share common beliefs or interests, such as religion or ethnicity, are targeted. The fraudster exploits the trust and friendship of those individuals, and proposes investments to individual members of the group. Smaller, close-knit communities are often considered easier targets in affinity frauds. In our research, the following cases involved affinity frauds:

[21] See Canadian Securities Administrators Investor Education Committee, *CSA Investor Index 2009* online at: <http://www.securities-administrators.ca/uploadedFiles/General/pdfs/CSA%20Investor%20Index%202009%20Executive%20Summary_EN.pdf>.

- **Faith-Based Communities**
  - In Peterborough, regular church-goers were among hundreds of investors recruited by ***Andrew Lech*** to invest in 15 to 20% return investments. Investors' losses totalled almost $100 million.

- **Ethnic Communities**
  - Other easy targets for fraudsters are members of ethnic groups. ***Weizhen Tang***, the self-proclaimed "Chinese Warren Buffett", defrauded 200 Chinese Canadian investors of over $60 million in Ontario.

3. Enforcement of Securities Law Violations in Canada

3.1. Public Perception - There is a public perception (whether justified or not) that:

- securities scams go unpunished in Canada by both securities regulators and the police.
- investigations drag on for years and prosecutions (if any) take even longer.
- sanctions that are imposed by securities regulators for white collar crime are often viewed as inadequate.
- fines imposed by regulators are often left uncollected.
- individuals who are criminally convicted may get little jail time and are usually released on bail after serving only a small fraction of their sentence.

3.2. Administrative Proceedings - In Canada, the enforcement of securities laws can be effected through administrative proceedings (including those conducted by provincial regulators and SROs), quasi-criminal prosecutions under provincial securities laws, or criminal prosecutions under the Canadian *Criminal Code*[22]. Provincial securities commissions are the primary source for the enforcement of securities laws, through administrative proceedings.[23] Decisions and orders resulting from administrative hearings before the commissions can give rise to a wide variety of orders including:

- disgorgement;
- fine payments (up to $1 million in several provinces for each failure to comply);
- reprimands; and
- orders prohibiting individuals from trading in securities.

3.3. Securities Law Quasi-Criminal Prosecutions - Violations of provincial securities legislation can also be prosecuted as "quasi-criminal" matters. Quasi-criminal prosecutions are punitive proceedings that take place in provincial courts. These prosecutions are brought under the provincial securities acts rather than under the Canadian *Criminal Code*. Sanctions for securities law offences include:

- fines (up to $3 million in British Columbia and $5 million in several other provinces);
- prison terms for a maximum of five years less a day;
- payment of triple the amount of the profit made or the loss avoided;
- disgorgement; and
- payments of restitution or compensation.

3.4. Criminal Prosecutions - Prosecutions for violations of Canadian *Criminal Code* offences such as fraud affecting the public market, fraudulent manipulation of a stock

[22] R.S.C. 1985, c. C-46.
[23] Joseph Groia and Pamela Hardie, *Securities Litigation and Enforcement* (Toronto: Carswell 2007).

exchange, false prospectuses, statements and accounts can carry the most severe sanctions. Those sanctions include up to fourteen years' imprisonment and fines[24].

3.5. **Fragmented Enforcement Matrix** - The fractures in the enforcement matrix are many and varied, some inherent in the legal process, others reflecting a lack of overall national co-ordination, focus and resources for financial crime and other misconduct. Gaps and weaknesses in the enforcement system create opportunities for those who operate outside the limits of the legitimate financial services industry. The appearance of ineffective enforcement where substantial losses have occurred undermines public confidence in the system. Poor perceptions are exacerbated by the complexity of the industry/regulatory structure and the enforcement mechanisms. Investors may not understand how the losses occurred or who, or which among various issuers and market intermediaries, are legally responsible. The lines between criminal fraud, statutory violations and breach of business conduct rules are not clear to most consumers, yet this determines where or, even if, they can look for compensation for losses, whether a third party such as a receiver or securities regulator will work towards compensation or if they must pursue a private civil claim. Investigation of financial misconduct is expensive and time consuming, especially where the perpetrators are unwilling to co-operate. In the case of fraud, typically the investor funds are lost, or cannot be traced, even with resources to do so.

3.5.1. Responsibility for enforcement efforts following financial losses resulting by misconduct ranging from criminal fraud to breach of regulated conduct standards are fragmented in Canada along (1) jurisdictional , (2) operational and (3) legal process lines. There is a basic operational schism between criminal acts such as criminal fraud which are investigated by local municipal, provincial or national police and prosecuted by provincial crown prosecutors, and regulatory violations which are handled by provincial regulatory tribunals and local SROs through fines and suspension or revocation of license. The facts of a financial scandal such as Norbourg can cross provincial boundaries, and involve criminal conduct as well as regulatory violations.

3.6. **Inadequate Resources a Problem** - Resources, time, budget and expertise at the criminal or regulatory level may be inadequate for the frequently expensive and complex gathering and interpretation of financial evidence . Lines of communication between agencies may be broken or ineffective. Evidence gathering and use at the investigative and adjudicative stages can work at cross purposes between police and securities regulators.

3.7. **Fraudsters have More Rights than Victims** - Although the investor losses may be equally devastating, there are fundamental procedural and adjudicative differences

[24] Stiffer sanctions have been proposed in Bill C-21, which targets fraud sentencing and was introduced to help crack down on white collar crime and increase justice for victims. Its amendments to the *Criminal Code* (Canada) include a two-year mandatory minimum sentence for fraud over $1 million, a requirement for sentencing judges to consider making a restitution order to compensate victims of the crime, and additional specified aggravating factors for the court's consideration in sentencing. The Bill was passed by the House of Commons in December 2010 and will need to be passed by the Senate before it becomes law.

between sanctions for criminal conduct and a breach of provincial or SRO rules. Evidence gathered for a criminal prosecution is governed by the constitutional rights of the accused to fair process as is the pace of the proceedings. The victims have no such rights. All of the processes may take many years to work through the system. The rights of the accused in criminal matters are a key factor in prosecution and sentencing, while administrative bodies can proceed with more freedom and flexibility in imposing preventative regulatory sanctions. Results of regulatory and criminal investigations that may lead to regulatory sanctions or charges cannot be shared with victims for purposes of a civil claim.

3.8. **IMET** - The intended solution to fragmentation and public perceptions of ineffective enforcement, the Integrated Market Enforcement Team ("**IMET**"), has not been very effective from the perspective of wronged investors. Established in 2004 by the RCMP to tackle serious capital markets crime and coordinate with local police, regulators and investigators, the IMETs have suffered from a lack of publicized operational successes. According to its published data, since inception IMET has obtained ten convictions with sentences ranging between eighteen months and thirteen years. A flagship IMET prosecution, the Royal Group Technologies matter, which was allocated considerable time and resources, was recently soundly rejected by an Ontario judge who delivered a stinging rebuke to the prosecution for pursuing the case.

3.9. **Expert Agency Needed** - Financial markets and financial products have become increasingly complex and the legal and regulatory framework is equally, if not more, complex. A national enforcement agency staffed with experts in finance, law, accounting, technology and investigation is required to combat financial fraud. No such expert agency exists in Canada.

4. Regulatory and Criminal Enforcement of Fifteen Cases Reviewed

4.1. Regulatory Actions by Securities Regulators - Our analysis has revealed that enforcement by securities regulators was, in many cases, not adequate. Fines imposed by securities regulators were often not collected, and the laxity of sanctions imposed, if any, did not send a sufficiently strong deterrence message to market participants or the public. Unfortunately, whether justified or not, inadequate enforcement can create the perception that investor protection is not a top priority for securities regulators. Below is our analysis of the sanctions imposed by securities regulators for securities law violations.

4.1.1. In several cases, securities regulators did not bring charges against the wrongdoers:

- The AMF cooperated with the Sûreté du Québec in ***Earl Jones*** and sought freeze and cease trade orders from the Bureau de décision et de révision ("**BDRVM**").
- OSC proceedings against Van Dyk and Rogers, the two principals in the ***Fulcrum*** have been suspended pending the completion of the criminal proceedings.
- In the case of ***Triglobal***, the AMF's investigation in Québec has been ongoing since December 2007. The freeze trade order originally issued by securities regulators in October 2009 has been extended.
- No securities enforcement action was undertaken in the British Columbia registered ***Vantage*** case.

4.1.2. In other cases, provincial regulators brought regulatory action but the sanctions were, in our view, inadequate:

- The regulatory case against ***Andrew Lech*** for securities fraud, which was first investigated in 2003, was resolved in May 2010. Lech was permanently barred from trading in securities or acquiring securities, reprimanded, and prohibited from becoming a director or officer of any issuer or investment fund manager. No fines were imposed.
- In ***Manna***, the BCSC imposed a total of $26 million in fines (divided among the four principals), in addition to ordering disgorgement and the repayment of $16 million to investors. It is unlikely that the fines will ever be collected. Three of the four principals fled from British Columbia. The one remaining in the province claims to have no assets to pay the fine or to repay aggrieved investors. The BCSC reports that investors received back as little as $3 million and no more than $5.6 million of their $16 million lost.

- In 2009, ***Ian Thow*** was initially fined $6 million by the BCSC, which was subsequently reduced to $250,000 by the British Columbia Court of Appeal. Thow has not paid the fine. On the criminal prosecution side, Thow pled guilty to twenty counts of fraud in 2010, and was sentenced to nine years in jail, which was two years longer than the recommended joint sentence submission. Thow appealed the sentence and the appeal was rejected by the BC Court of Appeal in November 2010.

4.2. Criminal and Quasi-Criminal Law Enforcement - On the criminal law enforcement side, there is a public perception that, in Canada, financial fraud is not accorded sufficient seriousness or weight by the criminal law authorities. In the majority of the cases reviewed by FAIR Canada, criminal charges have either never been laid, or remain pending. Even in situations where criminal convictions have been secured (such as with Earl Jones), the sentences imposed and the actual time spent in prison, in our view, have been too lax to offer any serious deterrent effect.

- The criminal case involving the ***Brost, Sorenson et al.*** scheme brought against Brost and Sorenson has been pending since their arrests in 2009.

- After being charged with fraud and theft by the Sûreté du Québec in July 2009, ***Earl Jones*** pled guilty to two fraud charges. On February 15, 2010, Jones was sentenced to 11 years in prison. Jones will be eligible for parole in December 2011.

- In the ***Essex*** case, a plea bargain was reached on the 30 counts of fraud against each of Allen and Moriarty. Allen was sentenced to four years in jail and charges against Moriarty were dropped.

- In the ***Manna*** case, the BCSC referred the case to the RCMP in 2007. To date, the RCMP has not laid any charges.

- ***Norbourg***'s principal, Vincent Lacroix, was charged with fraud in 2007. He initially received a 12 year sentence and a $250,000 fine. In July 2009, Lacroix was released on “day parole”. In September 2009, the sentence was reduced to 5 years minus 1 day as the Court of Appeal ruled that the Québec Code of Penal Procedures required Lacroix’s entire sentence to be served concurrently. Lacroix was then granted full parole, with conditions. Lacroix was subsequently brought back on other charges and was given a 13-year sentence, said to be the largest for white collar crime in Canadian history. Lacroix was conditionally released in January 2011, after serving 16 months of his 13-year sentence. (Although the latter sentence was precedent-setting in Canada, sentences of 50 years or more are not uncommon in the United States. For example, recent sentences have been handed out to Bernie Madoff for 150 years and Richard Harkless for 100 years).

- In the ***Portus*** case, more than five years have passed since the scandal came to light in August 2005, and the criminal trial against Boaz Manor (one of the Portus principals) remains pending.

- The criminal fraud case against ***Weizhen Tang*** remains pending. The preliminary hearing is scheduled for February 14, 2011.

- The RCMP confirmed in late 2008 that it was conducting a criminal investigation in the ***Triglobal*** case. Charges, if any, have yet to be laid.

- To our knowledge, no criminal charges were laid in the ***iForum and Vantage*** cases.

4.3. **Parole** - In Canada, financial fraud is considered to be "non-violent". In the cases of first-time, non-violent offenders, unless the Parole Board of Canada has reasonable grounds to believe the offender will commit a violent offence before the end of his or her sentence, it must, by law, direct the release of the offender on day parole at six months or one-sixth of the sentence, whichever is longer, and on full parole at one-third of the sentence. In the U.S., offenders generally serve 90% of their sentence before parole is granted, making sentences there much more reflective of the time that will actually be served.[25]

[25] This may change with the passage of Bill C-21.

5. Inadequate Recovery of Losses by Investors

5.1. **Compensation Options in Canada** - Public outcry about the lack of or inadequate punishment is further aggravated by the fact that, in many cases, victims of financial fraud recover very little of their losses, if anything at all. In Canada, there are limited options available to investors who wish to recover losses sustained as a result of an investment fraud.

5.2. **Non-Registered Persons** – Practically speaking, investors that deal with non-registered firms or individuals have very limited options, options which are quite costly and only meaningful if there are assets that can be located and seized. These include: disgorgement and restitution; civil causes of action; mediation or private settlements; and distribution of funds on receivership. Disgorgement and restitution are only available from some provincial commissions and only meaningful when fraudsters have assets that can be located and seized. Some provincial and territorial regulators do not have the power to make orders for these types of relief.[26] In addition, the distribution of funds on receivership is only available in circumstances where there are assets left to distribute and, unfortunately, there are often few, if any, assets remaining after frauds have been committed.

5.3. **Non-SRO Registrants** – Investors that deal with a non-SRO member registered firm or individual do not have access to a compensation fund but can be compensated through broker-dealer insurance, where available and, in the province of Québec, through the FISF. Investors can be paid out of broker-dealer insurance only where there is insurance coverage and the loss is insurable. In addition, as noted in this report under section 1.12., the FISF compensates investors in Québec, in very limited circumstances for fraudulent acts committed during the distribution of financial products and services.

5.4. **Registrants that are SRO Members** – Investors that invest through SRO member registrants are compensated through available compensation funds in the event of insolvency of the firm. Where the firm is not insolvent, there are assets so that some recovery via alternative avenues is possible: OBSI non-binding dispute resolution, IIROC arbitration proceedings (for investments made through IIROC member firms) or civil litigation are options.

5.5. **Recovery Breakdown** - In the scandals reviewed by FAIR Canada, approximately $915 million of the $1.9 billion Total Loss was recovered. The recovery can be broken down as follows:

- $39.2 million from compensation funds;
- $4.3 million through disgorgement;
- $169.4 million in assets or other claims recovered by a receiver;

[26] Expert Panel on Securities Regulation , *Final Report and Recommendations, January 2009*, online: <http://www.expertpanel.ca/eng/documents/Expert_Panel_Final_Report_And_Recommendations.pdf> at page 35.

- $690.1 through settlements/class actions (mostly from Portus); and
- $12 million in repaid fees (Portus only).

Excluding the Portus case, which is an outlier of a case (as discussed at footnote 20), recovery was as follows:

- $39.2 million from compensation funds;
- $4.3 million through disgorgement;
- $26 million in assets or other claims recovered by a receiver; and
- $78.2 through settlements/class actions.

5.6. Examples of Loss Recovery – In three cases, victims received recovered losses from compensation funds.

- In 1999, approximately $6.4 million was paid out to investors of ***Essex*** from CIPF, the compensation fund for IIROC members.

- In the ***Norbourg*** case, approximately $112 million of the $115 million of total loss has been repaid to investors from recovery by the receiver (approximately $26 million), compensation from Fonds ($31 million), and class action settlement ($55 million).

- In the 1998 ***Vantage*** case, the full recovery of investors' losses was approved by the BC Supreme Court and paid from a surety bond held by Vantage and the BC contingency fund (which is no longer in existence).[27]

5.7. Civil Actions – Civil litigation result in some cases or is currently being pursued in others.

  - Investors who were scammed by ***Earl Jones*** brought a class action against the Royal Bank of Canada's ("**RBC**") Montreal-area branch that handled much of Jones' banking. The trial has not begun, but victims claim that RBC provided Jones with irregular and inappropriate privileges that enabled him to carry out his scheme.

  - A class action judgment was issued in 2001 against ***Essex***, Nelbar, Allen and Moriarty for $10,610,808 plus interest. Allen unsuccessfully appealed the judgment against him in 2006. $6.4 million was ultimately paid to investors by the CIPF.

  - In June 2010, the $21 million class action settlement for compensation for investors in the ***Farm Mutual*** case was approved. The net payment to the class under the settlement was $17.5 million. Investors in that case lost a total of $50 million.

[27] Note, however, that any registrants previously belonging to the BC contingency fund are now members of the CIPF or the IPC.

- A class action award was made in the ***Lech*** case in December 2004. Investors are expected to recover less than 2 cents for every dollar lost.

- ***Portus*** investors were able to recover $611.9 million in losses through a private settlement with Société Générale in 2009. Under the settlement agreement, Société agreed to repurchase the deposit instruments underlying the Portus investments.

- In the case of ***Triglobal***, a number of individual investors brought civil actions against Papadopoulos, with one investor successfully suing him for $14.3 million. However, Papadopoulos later fled to Greece, so the plaintiffs can only recover their losses if Papadopoulos returns to Canada or if the plaintiffs incur the expense of enforcing the judgment in Greece and locating the assets.

5.8. Distribution of Funds on Receivership - When individual investors are shareholders in the companies in which they invest, upon the wind-up or dissolution of a corporation, they have the right to any remaining property only after all debts have been satisfied. If they are creditors then they would share in recovery with other creditors.

- About $26 million was recovered by ***Norbourg***'s receiver, Ernst & Young. The money went to Norbourg's creditors, which included a number of investors.

- In March 2007, RSM Richter, a receiver for ***Norshield***, estimated that only 6 to 9 cents on the dollar would be recovered on behalf of Norshield's investors. The case is still ongoing.

- In ***Portus***, in addition to the funds recovered through the settlement with Société Générale ($611.9 million), KPMG was able to locate $143.4 million out of a total of $793.9 million. Those funds were distributed in full to investors by the end of December 2009.

5.9. Compensation for Victims of Fraud by Registered Firm - FAIR Canada believes that investors should be protected from losses that result from fraud leading to insolvency of, all registered firms and individuals, at all levels of the investment chain whether by means of a compensation fund, insurance or otherwise. However, creating a national compensation fund that covers fraud leading to insolvency of all government licensed firms would not be a perfect solution for victims of financial fraud and could be challenging for many reasons, including the following:

- Federal legislation would be required and this would only be seriously contemplated by the federal government in the context of a national securities regulator. The most optimistic forecast for the establishment of a national regulator (from the CSTO) is mid-2012.

- Funding of a national compensation fund will need to come from government or the financial industry and is likely to be contentious.

- The new national fund would need to merge with the existing funds (CIPF and IPC) to avoid a multiplicity of funds.

- Firms that currently contribute to CIPF and IPC may resist the notion of a national fund or of expanding the existing funds to include registrants that are currently not SRO members, particularly if that translates into higher fees for existing SRO members.

- Such a fund would not cover fraud committed by non-registered firms or individuals.

5.10. Mandatory SRO Membership for all Registrants - **FAIR Canada recommends that all registrants be required by securities regulators to become a member of an existing SRO that is backed by an existing compensation fund.** Given the existence of compensation funds and our finding that a small percentage of the Total Loss could be traced back to SRO member firms, we believe that advantages of mandatory SRO membership would include the following:

- The risk of fraud leading to insolvency of registered firms could be reduced.

- Investors would be compensated in the event of any registered firm's insolvency.

- As SRO members are ultimately responsible for funding the existing compensation funds, all registered firms would have "skin in the game" since their members would, through the compensation fund, need to reimburse investors in the case of a firm insolvency. Greater incentives would exist for SRO members (essentially including all registered firms) to ensure that high standards of conduct were followed by all members of that SRO, to keep compensation fund premiums low.

5.11. "Skin in the Game" - Our research did not try to determine the reason(s) why fewer financial scandals were linked to registrants who were also SRO member firms as opposed to registrants directly regulated by the provincial securities commission. Is it possible that the existence of compensation funds may lead SROs members to have a greater vested interest in preventing and detecting fraud that could lead to firm insolvency, since they pay the premiums for the fund? Do SRO members support SROs imposing stricter compliance requirements and being more active in the day-to-day activities of their members, resulting in closer supervision and oversight? Do they have an incentive in passing on intelligence about potential problems to their SRO while they may be less willing to deal with a securities regulator? **The important point from our analysis was the finding that fraud leading to insolvency was rare among SRO member firms, even though those firms represent the largest percentage of business**

conducted by registrants in Canada.[28] **Further in the case of insolvency, investor losses were compensated through a combination of recoveries and payouts by the compensation fund.**

5.12. **Moral Hazard** - Protecting consumers from the fraud and insolvency of registered person does not create any "moral hazard". Consumers will not be protected from market risk if they make bad investment decisions. They will be protected from fraud leading to insolvency of firms licensed by government as being "fit and proper" to conduct an investment business. Consumers have the right to expect that government-licensed and regulated firms are not operating Ponzi schemes or perpetrating other frauds and that their investments and funds will not disappear. Expert securities regulators with statutory powers of supervision and industry self-regulatory organizations, both of which have teams of lawyers, accountants, investigators and other experts, are responsible for licensing and supervising registrants. If these well-resourced expert organizations are not able to identify fraud by registrants, how can we expect vulnerable consumers (who are often not even financially literate) to identify fraud by a registrant?

[28] In the approximately forty years since the CIPF was established, seventeen member firms have become insolvent with all cash and securities being returned to eligible clients, including a total payment from CIPF of approximately $35.5 million.

6. FAIR Canada Recommendations

6.1. **Recommendations** - FAIR Canada has a number of recommendations for securities regulators, governments, industry organizations, and Canadian compensation funds. Our recommendations focus on: (1) fraud prevention, (2) early detection of fraud; (3) better enforcement leading to more effective prosecution and stronger sanctions, and (4) improved compensation for victims of investment fraud.

FRAUD PREVENTION

6.2. **Launch Major Public Education Campaign** - In order to address the issue of Canadians, and in particular vulnerable groups, being targeted by investment scams, FAIR Canada recommends that a major public education campaign be launched by government, securities regulators and industry organizations to educate Canadian investors about fraud prevention including the importance of dealing with registered firms or individuals. SROs and their members should educate Canadians about the benefit of dealing with firms that are members of an SRO backed by a compensation fund. While regulators have made efforts to educate Canadians on how to avoid fraud, we do not believe that they are actually reaching the vast majority of Canadians and, in particular, vulnerable groups.

6.3. **Focus on Vulnerable Groups** - Particular focus should be on educating vulnerable groups, with a goal of identifying and equipping those groups with the necessary tools to detect and avoid financial fraud. The campaign should include advertisements or notices in publications targeting the elderly, ethnic groups (in various languages), religious groups, reaching out to organizations representing vulnerable groups. Innovative strategies need to be considered to reach out to vulnerable groups, such as the "God's Fraud Squad" initiative at the BCSC. This is a grassroots program developed by two Fraser Valley pastors, to prevent and disrupt cases of investor fraud in faith-based communities. The education campaign should make reference to the dangers of promises of unrealistic returns and guaranteed consistent returns and how they are often a red flag for fraud. FAIR Canada drafted a list of warning signs and tips for investors. See Appendix B to this report for a copy of the Spring 2010 "Virage" article entitled *Be a well-informed investor*.

FAIR Canada recommends that government, regulators and SROs launch a major public education campaign to educate Canadians about avoiding financial scams.

FAIR Canada recommends that regulators provide a comprehensive, plain language, "one stop" national system for the public to check registration status, background information (including proficiency and disciplinary record) and SRO membership.

6.4. Make Firms Responsible for their Advisors - Financial firms should be made financially responsible for rogue advisors they employ (like Ian Thow) who defraud clients, including where the broker was acting outside the business of the firm. A financial firm and its compliance function is best placed to supervise its advisor, it is best placed to communicate with the clients of the advisor to ensure that client funds are always transferred to the firm and never the advisor and firms are better able to obtain fidelity insurance to cover losses by rogue brokers.

FAIR Canada recommends that registered firms be made financially responsible for compensating clients that are victimized by a rogue advisor.

6.5. Whistleblower Duty and Incentives - Regulators and SROs should take a leaf out of the rules for professional conduct of the legal profession. Registrants should have a duty to report to a commission or SRO when they have knowledge that suggests that another registrant is engaged in unprofessional conduct. Registrants are often best placed to detect potential fraud or other misconduct by another registrant (whether an individual or firm). Reporting potential misconduct could lead to the misconduct being identified at an early stage and loss or damage to clients being reduced or eliminated. Government and regulators should also consider providing financial incentives to any person (other than a registrant) who reports serious misconduct to a regulator (including SRO) or police.

FAIR Canada recommends that regulators consider introducing rules that require all registrants to report potential serious misconduct by another registered person.

Financial incentives should be considered for members of the public who report potential financial fraud (whether the potential fraudster is a registrant or not) to regulators or police.

EARLIER DETECTION OF FRAUD

6.6. Devote Resources to Fraud Detection - We were surprised to learn that fraudsters who were not registered to undertake an investment business were openly advertising their investment services in newspapers and the internet (sometimes for years) before the fraud came to light. Some registrants that later went insolvent as a result of fraud or other financial misconduct were also advertising returns that should have been a red flag for regulators. We believe that regulators should have resources dedicated to fraud detection. For instance, staff should be reviewing newspapers and other media for advertising of investment services by persons who are not registered. The securities commissions should promptly investigate any advertisement by persons who are not registered and make it a practice to prosecute all persons actively conducting an investment business without a license. Similarly, securities commissions should scan the newspapers and media for advertisements by registered persons

which offer unrealistic returns and put these on a list of high risk registrants subject to early inspection. "Mystery Shopping" by commission staff should also be considered.

FAIR Canada recommends that regulators devote dedicated resources to financial fraud detection. We recommend that securities regulators engage in more proactive measures to detect and prevent fraud including reviewing print and other media advertising of investment services by unregistered persons and advertising of unrealistic returns by registered persons.

6.7. Reform Exempt Offerings to Accredited Investors - We regularly read about investment scams which ostensibly qualify as "exempt offerings" under securities laws based on the purchaser being an "accredited investor". Later it turns out that the so-called exempt offering contained serious misrepresentations and was made to unsophisticated consumers who did not qualify as "accredited investors". It is our understanding that, while filings are made with regulators for exempt offerings, regulators do not verify the veracity of exempt offering filings made with them.

6.7.1. Some offerings of securities are exempt from the requirement to produce a prospectus providing full disclosure, as well as other regulatory requirements. The primary rationale for the exemption is that the purchaser is a "sophisticated" investor who has the knowledge, experience and resources to obtain the information without regulatory protection. An "accredited investor" is one of the major so-called "sophisticated investor" exemptions and includes both institutional investors and ordinary people who have money but are not truly "sophisticated" investors. An "accredited investor" includes an individual who has financial assets in excess of $1 million or whose net income in the past two years was over $200,000 (or $300,000 when combined with the income of a spouse). There is no requirement that the person be financially literate or have knowledge and experience with investments. This effectively treats ordinary Canadians as being as financially sophisticated as institutional investors for purposes of purchasing financial products, subject to limited (or no) regulation. For example, the doctor who earns $200,000 per year, middle class "boomers" who have inherited money from their parents' estate, retired persons with $1 million in financial assets would all qualify under this exemption. The reality is that most Canadians do not have a basic level of financial literacy, let alone the financial sophistication needed to protect themselves in the "exempt market". Furthermore, fraudsters can easily sell to unsophisticated consumers who do not meet these financial tests as there is no independent verification that the individual even meets these financial thresholds.

Securities regulators should reform the "exempt offering" and "accredited investor" exemptions to ensure that they are not used to sell investments to unsophisticated consumers. Regulators should audit the veracity of exempt offering filings based on a risk assessment.

6.8. Require SRO Membership for all Registrants - Given the existence of compensation funds and our finding that a small percentage of the Total Loss could be traced back to SRO member firms, FAIR Canada recommends that all registrants be required to be members of an SRO backed by a compensation fund. Advantages to such an approach would include the following:

- Supervision and early detection of all registrants would be enhanced. The risk of fraud leading to insolvency of a registered firm could be reduced.
- Investors would be compensated in the event of a registered firm's insolvency as a result of investment fraud committed by the firm.
- Greater incentives would exist for all registrants to ensure that high standards of conduct are followed by all members of that SRO, to keep compensation fund premiums low.

FAIR Canada recommends that provincial regulators and governments mandate that all registrants be required to become a member of an existing SRO backed by an existing compensation fund. As a starting point, FAIR Canada recommends that provincial regulators, SROs and compensation funds convene a summit to develop a strategy to ensure that compensation funds cover fraud leading to insolvency of all registrants that deal with investors and to address gaps in compensation fund coverage[29].

ENFORCEMENT

6.9. Better Enforcement - Better investigation, enforcement, and prosecution of fraud is absolutely essential. Government and regulators need to send a clear message through tough, coordinated enforcement of securities law violations, that fraud will not be tolerated and will be investigated, prosecuted and punished through stiff sanctions. Investors are entitled to have confidence in the integrity and fairness of regulated securities markets and financial professionals.

FAIR Canada recommends that the federal and provincial Attorneys General, regulators and police convene a summit to discuss how Canada can do a better job of preventing, detecting and prosecuting investment fraud.

6.10. Create National Agency to Target Financial Fraud - FAIR Canada believes that a new national agency staffed by experts may be the most effective way to target

[29] In January 2011, the Québec Minister of Finance confirmed that the AMF would hold consultations on the issue of compensation for financial sector fraud victims. At the same time, a group of experts, including the Quebec Coalition for the Protection of Investors (of which Robert Pouliot is a co-founder) has proposed the creation of a universal compensation fund for victims of fraud in the financial sector.

investment fraud and other financial fraud in Canada. Canada needs a national antifraud organization reporting to the Attorney General of Canada, lead by senior securities experts (with backgrounds in law, accounting, finance and technology), dedicated to protecting investors and fostering confidence in capital markets. A body of this type has been consistently recommended or supported by the reform–oriented task forces appointed over the last decade and their research experts.[30] The problem in a fragmented system is to find the leadership prepared and able to take charge of such an initiative.

FAIR Canada recommends that the Federal Government consider the creation of a national agency staffed by financial experts under the Attorney General of Canada to specifically target investment and other financial fraud.

COMPENSATION FOR VICTIMS OF FRAUD

6.11. Securities Regulators Need Consistent Powers to Compensate Investors - Consistent with the recommendations outlined in the Expert Panel Report[31], FAIR Canada supports the recommendation that a securities regulator have the power to order compensation. At a minimum, compensation powers across all provincial and territorial securities regulators should be clear and consistent. The proposed national regulator should have such a power.[32]

Securities regulators should have consistent statutory powers to order compensation for victims of financial scams.

6.12. Express Mandate for Securities Regulators to Seek Compensation for Victims - In their research and recommendations to the 2006 Task Force to Modernize Securities Legislation in Canada, Cory and Pilkington[33] surveyed the plethora of reform proposals and research studies already generated in Canada and concluded that essential improvements to the enforcement of securities laws included (1) express authority for securities regulators to apply to a court for compensation for victims of financial losses, (2) greater use of existing powers of this type, (3) new powers for securities tribunals to order restitution and (4) jurisdiction for courts to order

[30] See for example, Poonam Puri, *A Model for Common Enforcement in Canada, The Canadain Capital Markets Enforcement Agency and the Canadian Securities Hearing Tribunal*, Research Study Prepared for the Expert Panel on Securities Regulation, 2009; Cory and Pilkington, infra Note *; *Blueprint for a Canadian Securities Commission*, Crawford Panel on a Single Canadian Securities Regulator, 2006; Charles Rivers Associates, *Securities Enforcement in Canada: the Effect of Multiple Regulators*, Research Study Prepared for the Wise Persons Committee, 2003.

[31] Expert Panel on Securities Regulation, *Final Report and Recommendations, January 2009*, online: <http://www.expertpanel.ca/eng/documents/Expert_Panel_Final_Report_And_Recommendations.pdf>.

[32] In this report, we have not delved into an analysis of the potential difficulties associated with having securities regulators directly compensate investors, including the type of focused resources and expertise that may not be currently available at Canadian securities commissions.

[33] Peter de C. Cory, Marilyn L. Pilkington, Critical Issues in Enforcement, Research Study for Task Force to Modernise Securities Legislation in Canada, 2006

restitution. They also noted that there is much commentary on enforcement inefficiencies and plenty of proposals for rationalisation, but as yet no detailed research information exists as to the actual performance of the securities enforcement system in Canada. This situation has not changed significantly since 2006. Cory and Pilkington recommended a special body be established to gather and rigorously analyse enforcement data. FAIR agrees this is necessary. In the absence of this, the fragmentation enforcement agencies, bodies, goals and mandates in Canada will continue to strike all commentators as intuitively problematic, but effective solutions will remain elusive.

6.13. **Regulators to Prioritize Protecting Investors** - We believe, however, that right now Canadians expect a more active role from regulators in compensation and restitution for victims of financial abuse, particularly in complex fact situations. The recent unanimous all-party Ontario Legislative Committee report on the OSC[34] suggests that elected officials also believe that the public expects more from securities regulators. We believe that regulators should make victim compensation a priority. Where regulators are able to achieve financial settlements as part of an enforcement proceeding, we believe that the money should be distributed to victims unless they have already been otherwise fully compensated.

6.13.1. FAIR Canada recommends that securities regulators have a clear, nationally-harmonized mandate to seek compensation for investors. There can be no reasonable argument for regional disparities in this regard. In addition to Cory and Pilkington's proposals, in the event of fraud and misappropriation, these measures could take the form of increased cooperation among receivers, the police and others in order to ensure the most timely and inexpensive recovery possible of investors' lost funds. These changes will not ensure that all victims of investment fraud will be fully compensated but they will increase the prospects of compensation and assist victims in recovering whatever assets may be available.

FAIR Canada recommends that securities regulators be given a clear mandate to seek compensation for victims of financial fraud.

[34] Ontario, Legislative Assembly, Standing Committee on Government Agencies, "Report on Agencies, Boards and Commissions - Ontario Securities Commission", *Official Records of Debates (Hansard)*, online: <http://www.ontla.on.ca/committee-proceedings/committee-reports/files_pdf/OSC%20Report%20English.pdf> (March 29, 2010).

7. Appendices

Appendices to February 2011 FAIR Canada Report "A Decade of Financial Scandals"

Appendix A – FAIR Canada Review of Canadian Financial Scandals: 1999 to 2009

Appendix B – "Be a well-informed investor", article published in Spring 2010 edition of *Virage*