

Perspectives On Regulation, Regulatory Systems and Regulators: Closing the Gaps

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Good morning and thank you for inviting me to come and share some of my perspectives with you today.

When Bryan Davies and Michael Palozzi asked me to speak this morning, they mentioned several topics that were of interest to you. These include investor protection and guidelines; good corporate governance systems; and corporate responsibility. I don't think they expected me to address all of these topics. But I am going to do so with a view to showing you how these seemingly disparate topics are related.

I am also going to talk about the fragmentation that plagues the financial services industry, its regulators and the public. And finally I am going to try to demonstrate why it is important for each of you in your daily work to recognize that fragmentation undermines effective, efficient regulation of the financial services sector and that you need to be continually mindful of ways to overcome this to protect the public interest and enhance public confidence in the regulated sectors.

I rather expect that the words "protect the public interest and enhance public confidence in the regulated sectors" resonate well with you. After all, they echo your mandate. And your mandate is a good starting point to illustrate the theme of my remarks.

The FSCO mandate, as you know, goes on to state that FSCO provides regulatory services that protect financial services consumers and pension plan beneficiaries and support a healthy and competitive financial services sector. This is an excellent mandate.

But it leaves some gaps – gaps that are not your fault but rather are the fault of Canada's fragmented regulatory system. It is these gaps that undermine the public interest and the public confidence in the financial services industry that you seek to protect and in its regulators.

I know from reading your draft Statement of Priorities that you are sensitive to this. You have identified, as one of your key challenges, convergence and the need to address issues facing the financial services industry through a cross-jurisdictional, cross-sectoral approach that is applied on a national basis. In fact, FSCO has played a leadership role in facilitating and supporting the Joint Forum of Financial Market

Regulators and CAPSA in their endeavours in this respect. But there are still gaps. In pointing them out, I do not mean to be critical of what FSCO has accomplished but rather to raise your awareness that there is much more to be done by FSCO, other regulators, governments, industry and individual Canadians.

The Regulatory Gaps

So let's look at the gaps. The current regulatory model is full of them. First of all we still have a regulatory system that is fragmented both jurisdictionally and sectorally. It is out of step with marketplace realities. Efforts to rationalize the system are elusive.

Products that look alike are regulated differently depending upon who issues them and who sells them. Disclosure requirements concerning the products vary according to who issues them. Registration, licensing and competency requirements vary according to what products are sold and what type of advice is given. Some products (such as deposits) do not require registration or licensing to provide advice about them or to deal in them. In most provinces, anyone can call himself or herself a "financial planner" or hold themselves out as providing financial planning advice. Depending on what the financial planner does, the person may or may not be subject to any regulation. Rights, obligations and the means to enforce such rights and obligations vary from province to province.

The ramifications of these differences in regulation are not readily apparent to consumer/investors³ and are not well understood. Yet efforts to bring about change have been fiercely resisted. Examples include the lobbying efforts that defeated bringing in a financial planning proficiency rule and that excluded insurance and certain other activities from regulation by The Mutual Fund Dealers Association of Canada. By the time a consumer/investor becomes aware of the differences in regulation or that there is no regulation, it is usually too late. The damage to the consumer/investor has occurred and there is little chance of satisfactory redress.

The regulatory scene is complicated by the fact that banks, insurance companies, trust companies, credit unions, independent mutual fund management organizations, independent mutual fund dealers and full service investment dealers now offer, directly or indirectly, a full range of investment advisory services and products. Many of them, through equity interests in other segments or sectors of the financial services industry or through strategic alliances or networks, have multiple entries into both advisory and distribution channels. Many of them operate on a national basis and have clients who move from province to province.

Another complicating factor results from the blurring, and in some cases, the fusion of product, function and advice. This has been driven by the industry's need to gain market share and to protect income streams. The traditional product sales-oriented representative has evolved into, or is being replaced with, a relationship-oriented

advisory-based manager whose role is focused on acting as a conduit between consumer/investors and internal or external money managers.

These changes in the marketplace fundamentally change the regulatory model as well as the type of regulation that is needed to protect consumer/investors whose needs are both integrated and multi-faceted. This is particularly so at a time when Canadians are being encouraged to become less reliant on governmental social, economic and retirement plans and to take on the risk (and the opportunity) of participating in corporate and private retirement plans.

Integrated Regulatory and Supervisory System

In this environment, one of the most effective ways of filling the gaps and benefiting Canadians would be to create an integrated regulatory and supervisory system. This system, which I recommended five years ago in my 1998 Report, would centralize, coordinate and streamline financial services regulation in Canada. It would integrate the separate existing four-pillar regulators into an integrated regulatory body that would operate throughout Canada. This regulatory body would be a free-standing, self-funded agency. It would be created by agreement among all federal, provincial and territorial governments in Canada. It would combine functional, prudential and institutional regulation – all of which are needed to ensure the effective, efficient operation of the capital markets and the protection of investors.

What I am in effect suggesting is a form of “privatization” of financial services regulation. I am recommending the de-politicization of such regulation. This would not only enable the rationalization of financial services regulation, it would enable such regulation to be refocused around the reality of the marketplace under an umbrella financial services authority that would be managed and staffed by persons with expertise in the financial services industry drawn from current regulators and industry participants.

The system I am describing would include a Canada-wide registration or licensing system for all intermediaries who deal with the public that reflects the integration of function, product and advice that has occurred in the marketplace and is centered around advice-giving rather than product licensing. Educational and proficiency requirements would center around advice-giving rather than product-licensing, with product knowledge being an integral part of the requirements. To do this effectively, there is a need to establish a financial planning and investment advisory standard for Canada. This standard should not be set by the industry alone. It needs to be identified, monitored and maintained by an independent, non-partisan standards council made up of knowledgeable people from the fields of education, business, industry, government, regulators and the Canadian public.

The integrated, advice-focused system that I have described would provide for a common regime for money management and would include the oversight of pension and other retirement funds. It would eliminate the need for multi-

registrations, multi-regulators and multi-self-regulatory organizations while at the same time providing for adequate, uniform and functional oversight, supervision and regulation.

Some of you may be wondering why I would bring up this recommendation at this time. Let me assure you that I am all too aware of the resistance that is being encountered to the current proposals to integrate securities regulation on a national basis. I am also aware of the fact that the proposals to merge FSCO and the Ontario Securities Commission seem to have died on the order paper with little enthusiasm to revive them. These facts are unfortunate. But they do not take away from the need to implement the proposals and fill the gaps created by the current systems.

Regulatory cooperation such as exists under the auspices of the Joint Forum of Financial Market Regulators is important and helps but it is no substitute for an integrated regulatory system. It's better than nothing but it is not a solution.

The bottom line is that the cost (and I'm not just talking about administrative costs) of continued multi-jurisdictional, multi-layered, fragmented regulation is too great a burden on Canadians and is not meeting their integrated financial planning and investment advisory needs. We have to find a way to achieve a unified, streamlined structure to meet these needs. You have an important role to play in this. Your expertise is crucial in bringing this about. You needn't fear for your jobs. Your work, and more, still needs to be done and a lot of it needs to be done "right here" – in the provinces and on the ground, so to speak.

The Knowledge Gap

Let me talk now about another gap – the "knowledge gap". This is the gap that exists between those who know and those who do not. This knowledge gap, which economists refer to as "informational asymmetry", usually operates to the disadvantage of consumer/investors and results in their making unsuitable decisions to meet their needs or in their receiving too little value at too high a cost. I don't think regulators pay enough attention to this problem.

The knowledge gap sometimes extends beyond consumer/investors to the regulators with there being too wide a knowledge gap between them and those they regulate. This skews regulatory decision-making and results in a system that often operates to the disadvantage of consumer/investors.

The knowledge gap is another reason why a regulatory strategy based on the neo-conservative, bull-market mantra of letting free market forces prevail falls short of protecting consumer/investors. Such a strategy is fine where there is a level playing field and all the players on it are fully informed, have the ability to apply their knowledge to their decision-making, and have meaningful bargaining power. But this situation does not exist and letting free market forces prevail works to the disadvantage of vulnerable consumer/investors. In this environment, the regulatory

strategies of disclosure and licensing of intermediaries are not effective by themselves. Regulators have to pay attention to the merits of the products and the quality and scope of the advice being offered. They need to monitor the playing field to ensure that the economic interests of consumer/investors are aligned with those who create, sell or offer advice about the products (including advice) that are being sold to consumer/investors.

One of the most effective ways of leveling the playing field is to ensure that consumer/investors have ready access to timely, quality information. But this has to be combined with measures to enhance their knowledge and awareness and their ability to apply this to make sound decisions. If consumer/investors do not have the fundamental ability to understand and make use of the information that is communicated to them, none of the other consumer protection remedies (particularly those based on disclosure) will work effectively.

The need to enhance knowledge and awareness and to build key competencies for consumer/investors, industry participants and regulators alike to enable them respectively to make use of the information that is communicated to them is a theme that underlines all of the recommendations in my Reports and particularly the ones in the 1998 Report. If you haven't read them, or if it has been awhile since you've read them, I think you would find it worthwhile to have a look at them. They are pretty topical.

The Work Gap

I'm now going to talk about another gap – one that I will simply call the “work gap” for lack of another phrase. I am referring to the multitude of discrete projects that are underway by different regulatory groups that deal with the same or similar issues – often with no coordination. For example, the issue of disclosure comes up in the Joint Forum's work on capital accumulation plans, enhanced disclosure for segregated funds and mutual funds, the CSA's work on continuous disclosure, mutual fund governance, proxy solicitation and the OSC's work on the Fair Dealing Model. This is highly inefficient and not very effective. It's another argument in favour of establishing the integrated regulatory system that I've just talked about. At a minimum, there's a huge need to apply some project planning skills!

The Consultation Gap

Yet another gap is the “consultation gap”. All these work groups that I've just mentioned are issuing proposals for comment. Yet consumer/investors, who are the people most affected by the proposals, are often unaware of what is being proposed or are not able to evaluate the proposals and articulate their concerns. Comments for the most part come from the industry and reflect their biases. Regulators often look to the industry for advice and suggestions so it's not surprising that the voice of consumer/investors is subsumed to that of the industry.

There are a handful of people who are trying very hard to change this but it is difficult for them to do so. It is particularly frustrating for them (and abusive of the process) when regulators implement the proposals on which they are seeking comments via exemption orders for which no public notice is given and no opportunity to be heard is provided.

Regulators are beginning to exhibit some sensitivity to the need for input from consumer/investors. They are utilizing surveys, focus groups, and consumers' councils. But these are not enough. Someone needs to be appointed to represent consumer/investors and to ensure that they have a meaningful role in the decision-making with respect to matters that will affect their financial well-being. There is a real need to give some thought to what would work to bring about this result. Remember, in the end, it's the individual investor who is paying the costs of the regulatory system. It's time to create an Office of the Consumer/Investor Advocate and vest such Office with the necessary powers to ensure that the interests of consumer/investors are effectively represented.

The Product Regulation Gaps

Still another gap that exists is what I call the "product regulation gap". For years, there has been concern that look-alike products such as mutual funds and segregated funds are regulated differently. A FSCO/OSC Task Force was struck years ago to deal with this. A lot of staff time has been used up and a lot of paper has been generated but little has been done to deal with the differences. I'm talking about nitty-gritty things like ensuring that there are common standards, consistently applied to portfolio valuation and the presentation of performance information, ensuring that there are fixed periodic valuation dates that are adhered to, ensuring that forward pricing is adhered to, requiring performance to be shown net of fees, and requiring know-your-client/suitability requirements to be met.

It's time to close the product regulation gaps and apply these long-standing mutual fund fairness requirements to segregated funds as well. Failure to do so may well be prejudicial to the interests of the holders of these funds and may well expose the issuers of segregated funds contracts to liabilities.

The Governance Gaps

I am going to tie my last gap – the gap between what is said and what is done – into what I have to say about governance. All of my remarks about governance apply to all types of governance – whether it be corporate governance, fund governance, personal governance or the governance of regulatory bodies.

Governance, as I see it, is simply the way we do things and some ways are better than others. This is why we need to look at who does what and how the respective players are accountable for their actions in carrying out an enterprise's mandate.

Good governance encompasses a set of integrated systems, controls and processes that must be continually monitored by internal and external personnel for effectiveness and adapted if need be. This isn't an optional need. It's a necessity. And the behaviour of individuals in whatever capacities they are serving – whether as directors, senior officers or employees, or as professional advisors, standard setters, regulators, self-regulators or overseers has to be aligned to ensure the effectiveness and integrity of what is done.

Good governance requires constant vigilance and questioning of the soundness of assumptions and basic procedures. It requires periodic zero-based analysis focused on: "Are we doing the right things, right? It requires an organizational culture that is committed to integrity and excellence. It requires everyone in the organization to be driven by this organizational culture, to be focused on doing right things, right and to understand the significance of their role and contribution in this respect.

Most people have no trouble agreeing with this. But many people have difficulty in recognizing or are willfully blind to, situations where what they actually do varies from what they and their governing principles say they do. Enron is a classic example of an enterprise with a perfect governance structure and score but abysmal actual operations and oversight.

The gap between what is said and what is done is one of the most essential to close. It's the gap that usually gets people into trouble and it is one of the most challenging gaps for regulators charged with oversight to identify. Yet it is the most essential gap for regulators to close in order to fulfill their mandate.

This gap between what is said and what is done is one that will require increasing attention as regulators look to guidelines, such as those that are to apply to capital accumulation plans and pension plan governance, as their regulatory tool. I think there will be a need for regulators to become much more proactive than they have perhaps been in monitoring what is actually being done as opposed to what people say is being done and in evaluating whether what is being done is adequate to protect plan participants. I'll be interested to see what you and other regulators will do or will be able to do if you find a problem. The draft guidelines that I read didn't seem to address this issue.

It may be that you will need to extend your excellent dispute resolution services to this area!

Corporate Responsibility

I said that I would talk about corporate responsibility and try to tie it into the other subjects I have talked about. I view corporate responsibility as part of an enterprise's values system that drives what it does. Corporate responsibility recognizes that there are other key stakeholders than just shareholders whose needs must be addressed if the enterprise is to thrive. Key stakeholders include employees, creditors, and the

community. Translating corporate responsibility into action is part of the governance process and the corporate culture I just talked about. Shareholder activists increasingly are asking the corporations in which they invest to disclose their policies in this regard and to discuss the impact of some of their activities on the community at large. Some pension and other investment funds take, or are required to take, these factors into account in deciding whether to invest in an enterprise. The argument is that because corporate responsibility activities flow through to impact the bottom line, it is important that investors to know what the impact of the corporation's corporate responsibility attitude and actions is likely to be.

This is a very rough overview of a vast, important subject. I have not done justice to the subject and you might want to ask a future speaker with expertise in this area to talk to you about it.

Conclusion

Let me conclude my remarks this morning by saying that these are increasingly challenging times for regulators. One seldom hears anyone saying "what a good job regulators are doing". Perhaps this goes with the territory; perhaps not.

There is no question though that we are going through a period that has exposed fundamental problems with the **way** things are done and with **what** things are done – or, in other words, with governance. What is important in this environment is that you take this to heart and continually review what you are doing, how you are doing it and how effective it is to fulfill your mandate. Your focus should be on the consumer/investors who are the subject of your mandate and you should not be afraid of change if change is what is required to better serve their needs. After all, without consumer/investors the industry is nothing. It's time to close the gaps.

Thank you for the opportunity to share my perspectives with you today.

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² Glorianne Stromberg is the author of three reports on regulatory strategies relating to the financial services industry:

1. *Regulatory Strategies for the Mid-90s - Recommendations for Regulating Investment Funds in Canada*, prepared for the Canadian Securities Administrators, January 1995. (Available in electronic form at <<http://www.osc.gov.on.ca>>)
2. *Regulation and Supervision of Investment Funds in the New Financial Landscape - A Canadian Perspective* presented by Glorianne Stromberg as part of the background material for the third session of the Expert Meeting on Institutional Investors organized by the OECD Committee on Financial Markets in July of 1997. (1998 OECD Publications, *Institutional Investors In The New Financial Landscape*, Page 449)

3. *Investment Funds in Canada and Consumer Protection - Strategies for the Millennium*, a Review by Glorianne Stromberg prepared for the Office of Consumer Affairs, Industry Canada, October 1998. (Available in printed form from Industry Canada's Information Distribution Centre by calling (613) 947-7466 and in electronic form at <http://strategis.ic.gc.ca/SSG/1/ca01120e.html>)

Ms. Stromberg served as a Commissioner of the Ontario Securities Commission during the period 1991-1998. Prior thereto she practiced law. Her practice concentrated on corporate and securities law matters with particular emphasis on the provision of financial services and policy development related thereto. Ms. Stromberg is a frequent speaker and commentator on matters relating to the investment funds industry, the financial services sector and the protection of investors.

The views expressed in these remarks are the personal views of Glorianne Stromberg. They do not necessarily reflect the views of any branch of Government or of any regulatory agency.

³ I use the term "consumer/investor" to describe the dual role of individuals who participate in today's marketplace. It is an inclusive term that describes us all.