

# Investor protection: Finding the balance

*Instead of more laws and regulations, the industry should rely on better oversight*

**T**HE RECENT GLOBAL FINANCIAL crisis exposed weaknesses in investor protection and highlighted a need for regulatory action to shore up investor confidence in financial markets.

In the U.S., the White House, Congress, the Securities and Exchange Commission and state regulators have responded with comprehensive proposals. As the U.S. financial markets were at the centre of the global financial meltdown, their aggressive response is not surprising. The crisis brought down four of the largest U.S.-based investment and commercial banks — Bear Stearns Cos. Inc., Lehman Brothers Holdings Inc., Wachovia Corp. and Washington Mutual Bank — and exposed the “too big too fail” dilemma facing others.

The short-term propping up of virtually bankrupt institutions and the fact that there has been no in-depth investigation of the banking system like the one conducted by U.S. lawyer and judge Ferdinand Pecora in the 1930s have left a public perception that these financial institutions were let off the hook. In addition, the crisis exposed two unprecedented Ponzi schemes, generating enormous negative publicity

and undermining confidence in the U.S. regulatory system.

The U.S. authorities have proposed significant reforms to strengthen the financial services sector and bolster investor confidence, including proposals to regulate systemic risk and to address the moral hazard of institutions that are “too big to fail,” new capital requirements, short-selling rules, enhanced disclosure, clearing houses for over-the-counter derivatives, regulation of rating agencies and additional consumer protection. Congress has moved in front of this reform process with draft legislation that contains a requirement that the SEC adopt rules imposing fiduciary obligations on brokers and dealers that provide investment advice, possibly like those currently applicable to registered investment advisors. This pre-emptive action, like the earlier Sarbanes-Oxley legislation (enacted in 2002), may be excessive and have unintended consequences.

This is arguably the case with the imposition of fiduciary duties on all brokers and dealers who provide advice to their clients. For example, the fact that the Madoff and Sanford firms were registered as investment advisors, with ac-

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companying fiduciary responsibilities under U.S. advisor legislation, did not deter or prevent their Ponzi schemes. Rather, their ability to “succeed” with their schemes for as long as they did resulted from a failure of regulatory oversight.

As U.S. Supreme Court Justice Felix Frankfurter (1939-1962) famously said: to say a person is a fiduciary “only begins analysis”; it does not determine the obligations owed to clients or the consequences of a failure to fulfil them.

It can be argued that existing know-your-client and suitability obligations and a duty to disclose and address conflicts of interest are adequate when a broker or dealer advises its clients. Most U.S. financial advisors are subject to these standards. A new fiduciary standard will require complicated rule-making to create specific rules and may impose significant compliance burdens on securities firms and their clients. Nevertheless, most registrants in the U.S. have not opposed this provision. Australia, as well, is considering imposing fiduciary obligations on its advisors.

Investor confidence in Canada has not been eroded to the same degree as in the U.S. because of the performance of our financial services sector in the crisis. The latest J.D. Power and Associates survey confirms that investment advisors are the most important drivers in investor satisfaction with primary full-service brokerage firms, and Canadian investors are generally satisfied with their investment advisors. Most investors surveyed would recommend their investment advisor to others. As a result, Canadian regulators have taken a more measured approach to reform.

Canadian reforms have focused largely on three areas: the need for better disclosure of the content and pricing of investments, particularly structured products; higher standards of registration and supervision of advisors; and regulation of client/advisor relationships. While some of these regulatory initiatives were triggered by the financial crisis, others began some years ago. It is expected, for example, that the **Canadian Securities Administrators** will introduce disclosure requirements for asset-backed securities and abbreviated formal information of

mutual funds (the *Fund Facts*).

In addition, the **Investment Industry Regulatory Organization of Canada** has proposed new rules for disclosure and pricing of debt securities traded OTC. The CSA's new registration reform system will improve advisor supervision and impose higher registration standards on dealers in the “exempt market.” And IIROC's proposed client relationship model will strengthen the integrity of the advisory process by building on the existing obligation of Canadian securities firms and advisors to deal fairly, honestly and in good faith with their clients. In short, the CRM will strengthen existing KYC and suitability obligations, regulate conflicts of interest and enhance ongoing disclosure to clients.

In all of these instances, Canadian regulators have focused on designing practical rules to achieve cost-effective regulation and have benefited from consultation with the industry. It is far from clear that any SEC rules that may be adopted to implement a fiduciary standard will do better. **IE**

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