

It's time for improved rules and regulations

Shaken by gyrating markets and huge writedowns, investors need assurances about the future

THIS PAST YEAR HAS BEEN A difficult one for investors. After peaking in July last year, the S&P/TSX composite index moved sideways on balance over the subsequent year, with dramatic swings in share prices. In the spring, the market reversed trend and made up some lost ground on the strength of rising energy and agricultural prices. This rebound was short-lived: almost a year to the day, Canadian markets collapsed through the summer months, giving up most of the earlier gains.

For investors caught in the crosswinds of difficult market conditions, the overriding concern has been the collateral damage of the enveloping credit crisis, particularly the health of the financial sector and global growth. Despite the collapse in share prices over the past year, retail and institutional investors have stayed the course, shifting portfolio focus to trading opportunities, especially in the early months of this year. Investor resilience has been remarkable, not just because of the unfolding international financial crisis, but because the homegrown asset-backed commercial paper issue was being played out at the same time. The bottom line is that average investors, assisted by their investment advisors, have retained confidence in the capital markets.

The staying power of investors is reflected in recent industry commission earnings.

GUEST COLUMN BY IAN RUSSELL

Quarterly retail revenues earned by members of the Investment Industry Regulatory Organization of Canada through the second half of last year and the first half of this year were roughly 3% lower than quarterly revenue in the bull markets of 2006-07. That's a substantially smaller decline than total industry revenues and earnings in the same period. The steady performance of the wealth management business once again demonstrates the importance of this business to overall firm and industry performance. Investment banking and institutional trading, on the other hand, have taken the brunt of market weakness and led the collapse in industry profitability this year.

The plunge in equity markets this summer, taking the TSX index down more than 1500 points, or 10%, aggravated investor stress. The widespread sell-off in commodity stocks caught investors by surprise, shifting the mood to greater pessimism and uncertainty. Other events darkened the mood further: write-down followed write-down; the devastated U.S. housing sector undermined balance sheets and weakened the economic outlook; the long-term outlook for commodities became clouded; and massive de-leveraging contributed to the market sell-off.

Negative sentiment about swinging markets caused investors to move at least temporarily to the sidelines, relying more than ever on professional advice. Preliminary industry data indicate that wealth management earnings have taken a downward turn from already lower first-half levels, and investor market participation is less robust.

Meanwhile, many regulatory initiatives are pending implementation. For example, we await the Canadian Securities Administrators decision on the regulation of ATs and are optimistic that new rules will facilitate cost-effective linkages with robust multiple markets; that should result in lower transaction costs and better trade execution.

We also need to bring closure to rules governing disclosure requirements at the point of sale of mutual funds, as these transactions require more clarity and practicality. The CSA review of shareholder communication rules and the need for new rules giving investors greater discretion, as well as requiring issuers to pay disclosure costs, need to be finalized. The regulators' Client Relationship Model, a much improved and practical version of earlier proposals, recently completed its comment period and, hopefully, suggestions for modifying the mandated disclosure requirements will be accepted.

The turbulence in capital markets — accompanied by mutating structural products, the spillover of credit risk from global

markets, and changes in domestic trading patterns, especially for derivative products — also point to the need for a vigorous and pro-active regulator. Such a presence is necessary to monitor national markets and the continued appropriateness of existing regulations, and to ensure orderly, fair and efficient markets. The IIROC has done a good job of regulating the capital market activity of dealers in these unprecedented conditions. But that is only one segment of the marketplace. The SROs also need a strong national regulator. We are hopeful that the Hockin Expert Panel on Securities Regulation will deliver a credible transition plan to a single common regulator.

We are optimistic about the eventual outcome of these initiatives — new and revised rules that will reduce costs for dealers and their clients, generate operational efficiencies and bring more practicality and clarity to the investment process. Final decisions on all these initiatives will provide a shot-in-the-arm to investors, reinforce confidence and encourage continued investor participation. Positive initiatives from the regulators could not come at a better time.

Ian C.W. Russell is president and CEO of the Investment Industry Association of Canada.