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Regulatory Capture Of Self-Regulatory Organizations (SROs) In Canada: Do SROs Serve Public Or Industry Interests?

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ABSTRACT

The Canadian securities industry relies heavily on self-regulation, with two self-regulatory organizations (SROs), the Investment Industry Regulatory Organization of Canada (IIROC) and the Mutual Fund Dealers Association of Canada (MFDA) regulating the industry. The former regulates all investment dealers and trading on Canada's debt and equities markets, while the latter governs domestic distributors of mutual funds, except fixed-income products. As expected in an SRO model of regulation, the structure of both IIROC and the MFDA presents a risk that industry members may influence or capture its operations, advancing industry interests at the cost of its public interest mandate.

This Article examines the current regulatory framework of IIROC and the MFDA, including their corporate governance structure and enforcement mechanisms. It finds that the existing structure of both SROs could favor industry interests above investors' (public) interests, as there are few safeguards in place to avoid the conflict of interests that is inherent to adopting an SRO structure.

Given the deficiencies of the current regulatory system, this Article assesses the implications of the proposed merger of IIROC and the MFDA into a single new SRO, concluding that it is a positive development. However, to effectively address the public's concerns with the current structure, this Article emphasizes the need for a more investor-focused approach in designing the new SRO regulatory framework and a more robust monitoring of the new SRO by the Canadian Securities Administrators.

Key words: IIROC, MFDA, SROs, securities law, self-regulatory organizations, public interest, regulatory capture.

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Section 1: INTRODUCTION

The question of what drives a regulatory process has been debated for many years. One school of thought holds the view that the purpose of regulation is to seek some conception of the public good, notwithstanding how unsympathetic, convoluted or unclear the regulation may be at a given time.[1] This is commonly referred to as the "public interest" theory of regulation. Opposing the public interest theory is the school of thought that views regulation as nothing more than an avenue by which special interests seek to use regulations or government power for a narrow advantage.[2] This is widely known as the "capture theory", "special interests theory" or "regulatory capture". This theory asserts that participants in the regulatory process have objectives that are more limited and focused on their own self-interest. In this approach, the influence of special interests is reflected in government regulation, which is then crafted and administered for the benefit of those interests. In other words, regulatory capture is more likely to occur where members of an industry are saddled with the responsibility of regulating their industries – otherwise referred to as self-regulation.

One of the core objectives of securities regulation is to protect investors, including customers or other consumers of financial services. Securities regulation, at least in theory, attempts to propagate the public interest theory of regulation. Interestingly, self-regulation

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[1] Michael E. Levine & Jennifer L. Forrence, "Regulatory Capture, Public Interest, and the Public Agenda: Toward a Synthesis" (1990) 6 Journal of Law, Economics & Organization 167 at 167, online: *Jsto*r < https://www.jstor.org/stable/pdf/764987.pdf?refreqid=excelsior%3A5e1aa277c771a7326bf315e49dde6f64&ab_segments=&origin=&acceptTC=1>.

[2] *Ibid* at 169.

is also an essential component of the regulatory structure of securities markets in many economies, including Canada. This use of self-regulation and of self-regulatory organizations (SROs) in emerging markets, as well as Canada, is intended to enhance the effectiveness of securities regulation and maintain market integrity.[3] The efficiency of a sophisticated regulatory framework and financial institutions is essential to the growth of a strong, fair and equitable financial market.

Thus, the use of SROs may lead to more efficient capital markets, thus enabling firms access to public equity and debt markets for capital at a reasonable cost, which supports business expansion and economic development.[4] For instance, SROs have been a component of the securities regulatory framework in the United States (U.S.) since 1939. The Financial Industry Regulatory Authority (FINRA), a non-profit SRO, regulates and supervises broker-dealers in the U.S. The purpose of self-regulation in the U.S. was to strike a balance that was mutually advantageous for the government and the securities industry — a system that would best serve U.S. financial markets. However, some jurisdictions, such as the United Kingdom (U.K.), have moved away from an SRO model, wherein securities regulation was performed by three separate SROs: the Securities and Futures Authority, the Investment Management Regulatory Organization, and the Personal Investment Authority. The legislature and the industry considered this as an unduly onerous

[3] Principles 6 and 7 of the Objectives and Principles of Securities Regulation of the International Organization of Securities Commissions (IOSCO) recognize that self-regulation may be a valuable complement to the regulator in achieving the objectives of securities regulation, but they do not advocate the use of self-regulation in any jurisdiction.

[4] John Carson, "Self-Regulation in Securities Markets" (2011) World Bank, Policy Research Institute Working Paper No 5542 at 2, online: file:///C:/Users/USER/Downloads/SSRN-id1747445.pdf.

requirement, which led to an increase in redundant expenses and a fractured regulatory framework.

Throughout its history, the Canadian securities industry has played an essential role in the regulatory and supervisory functions pertaining to the conduct of its members.[5] For almost two decades, the Investment Industry Regulatory Organization of Canada (IIROC) and the Mutual Fund Dealers Association of Canada (MFDA) have regulated securities trading activities in Canada. The IIROC monitors all investment dealers and trading activity on debt and equity markets in Canada, while the MFDA oversees all mutual fund dealers in Canada (except in Québec). The broad objectives of self-regulation are the same as those identified for government regulation of financial markets.[6] IIROC and the MFDA have public interest obligations and a broader duty to monitor and oversee members' or participants' behavior on the markets and in their interactions with clients. The wide, quasi-governmental responsibilities of IIROC and the MFDA are not only pursuant to recognition orders issued to both SROs by provincial securities commissions, but are also entrenched in their respective rules and by-laws and are designed to safeguard investors and preserve market integrity. Therefore, both SROs are supposed to prioritize the public interest above the specific interests of their members.

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[5] Although regulation is not the main function of most SROs, because most SROs are exchanges - for instance, The Nigerian Exchange. However, given that regulation is either their primary or only responsibility, IIROC, MFDA, and FINRA have been regarded as "pure SROs." Canadian securities regulation draws a distinction between SROs and Exchanges. See, e.g., *Securities Act* (Ontario), ss. 21 and 21.1.

[6] To (a) preserve market integrity, (b) to preserve financial integrity and (c) to protect investors. See *Model for Effective Self-Regulation*, International Organization of Securities Commissions (May 2000) at 2 online: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD110.pdf.

Notwithstanding the statutory backing of the public interest mandate and obligations of IIROC and the MFDA, the inevitable conflict of interest inherent in adopting an SRO model remains a controversial issue. According to an MFDA study, fewer than half of the public trusts that the SROs will make decisions that are in the public interest; 76% believe that conflicts of interest among SRO board members occur frequently and are not declared or eliminated before important decisions are made; and 60% of people believe that the current investment industry regulation model is not working and securities regulators need to be more directly involved.[7]

This Article investigates IIROC and the MFDA by analyzing the regulatory regimes of both SROs, as well as their respective corporate governance structures, in order to assess whether both SROs have adhered to their public interest mandate. It argues that the current SRO structure fails to serve public interests and does not succeed in striking a balance between its public interest mandates and its members' interests in order to prevent conflicts of interest.

This Article proceeds in five (II-VI) parts. In Part II the concept of regulatory capture and its enabling factors are discussed. Parts III and IV address the history, mandates and responsibilities as well as corporate governance framework of IIROC and the MFDA respectively. In ascertaining conflict of interests that arise in an SRO model, Part V touches on two points:first, that the regulatory functions and business interests of both IIROC and the MFDA are essential features of both SROs and are not mutually exclusive; second, that

[7] MFDA Report, "What Canadian investors want in a modern SRO" (8 September 2020) at 2, *online:* https://mfda.ca/wp-content/uploads/InvSRO_Report.pdf

the regulatory frameworks of both SROs are heavily influenced by special interests, and insufficient procedures are in place to adequately balance conflict of interests. Part VI then discusses the impact of the proposed merger of the IIROC and the MFDA on public interests. This Article then argues that the amalgamation of both SROs into one single entity is a step in the right direction and would better ensure efficient regulation of the Canadian investment industry while prioritizing its overarching public interest mandate.

Section 2: THE CONCEPT OF REGULATORY CAPTURE

Securities regulation has often been seen through the prism of the "interests" theory, which suggests that regulations are tailored to accommodate certain interests, although, in theory, these appear to be public interests. However, the notion of regulatory capture, which is rooted in the "interests" paradigm, posits that the interests accommodated are those of the very parties which the regulation purports to govern.[8]

Regulatory capture, therefore, is the result or process by which regulation, in law or application, is steered continuously away from the public interest and toward the interests of the regulated industry, by the intent and action of the industry itself.[9] It is projected that regulatory capture is more prevalent in the financial industry, where there is a direct conflict of interest between the regulators' – in this context, the SROs' – desire to protect the (investing) public and the interests of financial firms. As such, the capacity of the SROs to conduct investigations and impose sanctions on their members is directly impacted by the tension that exists between their regulatory responsibilities and their business goals.

We cannot effectively characterize regulatory capture without analyzing some of the enabling factors of the concept. First, regulators who come from the sector have more

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[8] George J Stigler, "The Theory of Economic Regulation" (1971) 2:1 The Bell Journal of Economics and Management Science 3–21 at 3, online: *Jstor* < https://www.jstor.org/stable/pdf/3003160.pdf?refreqid=excelsior%3A098dcf63c10d8184494bc0162c5d5708&ab_segments=&origin=>. In Stigler's regulatory capture hypothesis, a rule or regulation is acquired by the industry and is designed and operated primarily for its benefits.

[9] Daniel Carpenter & David A Moss, eds, *Preventing Regulatory Capture: Special Interest Influence and How to Limit it* (Cambridge: Cambridge University Press, 2013) at 13.

allegiance to the industry than to the regulating organization's objectives. Second, the duration of a regulatory regime's life cycle can lead to regulatory capture. Consequently, the longer regulators have been a part of the regulatory cycle, the higher their likelihood of being captured. Over time, such regulators develop a greater affinity for and identification with the industry. Based on the findings of a policy analysis of regulatory capture, several regulatory administrators claimed that "new surveyors go in gangbusters, but they mellow eventually".[10] To put simply, regulators become complacent. Bernstein's model[11] coheres with this assumption, wherein he argues that the formation of an autonomous regulatory body occurs between the "*gestation*" and "*youth*" phases, and that regulatory capture marks the transition from "*maturity*" to "*old age: debility and decline*."[12]

Third, authorities who view the sector as a potential career path are more lenient and understanding while regulating the industry. They consider their time at the regulatory organization as a training ground for a more profitable future involvement in the sector.[13] Fourth is information asymmetry. The regulator may depend on information provided by the regulated companies, such as information regarding pricing, expenses, and investment

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[10] Toni Makkai & John Braithwaite, "In and out of the Revolving Door: Making Sense of Regulatory Capture" (1992) 12:1 Journal of Public Policy 61–78 at 67, online: *Jstor* < https://www.jstor.org/stable/pdf/4007430.pdf?refreqid=excelsior%3Afee1abe2e2d72d85d621f44d7f45fa6a &ab_segments=&origin=>.

[11] Marver H. Bernstein, *Regulating Business by Independent Commission* (Princeton: Princeton University Press, 1955) at 74-95.

[12] *Ibid*. Bernstein argues that a regime reaches maturity when all parties agree on its powers and duties and when the independent regulatory body acts mechanically as a tribunal for the regime, and that a regime reaches old age when an industry has fully captured the regime and the regulatory body only seeks to maintain the status quo. See also: Michael Howlett & Joshua Newman, "After 'the Regulatory Moment' in Comparative Regulatory Studies: Modeling the Early Stages of Regulatory Life Cycles" (2013) 15:2 Journal of Comparative Policy Analysis: Research and Practice 107–121, online: *tandfonline.com* <http://www.tandfonline.com/doi/abs/10.1080/13876988.2013.765618> at 3-4.

[13] Toni Makkai & John Braithwaite, *supra* note 10.

levels. With skewed information, the regulator may be lenient with businesses, allowing price rises to support "essential investment," for instance.

Having examined some circumstances that give rise to regulatory capture, we will then explore the critical components of a regulatory capture as defined above.

Public Interest

The public interest theory of regulation holds that regulators seek to benefit the general public through regulations. In the context of securities regulations, for instance, the recently revised mandate of the Ontario Securities Commission (OSC), pursuant to section 1.1 of the Ontario Securities Act, aims to protect investors from unfair or fraudulent practices; promote fair, efficient and competitive capital markets, foster capital markets, foster capital formation and contribute to the stability of the financial system and the reduction of systemic risk. The capture hypothesis of regulation, on the other hand, asserts that no matter what the regulators' intentions are, those who are intended to be controlled will end up capturing or controlling the regulating body.

Thus, a thorough grasp of these two notions is necessary to comprehend capture. With capture, one purpose (the public good) is sacrificed in favor of another (industry interest).

Regulated Industry

From the above analysis, the concept of capture theory focuses on circumstances in which an industry takes advantage of regulation for its own gain. However, to reflect the fact that other regulated entities, such as labor unions, might manipulate regulation to promote their

own interests at the expense of the general public, one could theoretically substitute "industry" for the term "interests".[14] To be sure, businesses have an advantage when it comes to influencing legislation, which is why early studies of capture concentrated on corporate interests and how they attempted to influence the rules.

Intent

According to the above definition of regulatory capture, the notion that an industry is well-served by regulation is woefully inadequate for determining capture. Both intent and activity are necessary from the regulated industry.[15] There can be no capture until the industry (or a portion of it) deliberately and intentionally pushes regulation away from the public interest. The fact that industry gains from regulation is inadequate on its own, since it might be explained by bureaucratic drift, happenstance, or blunders, or as a simple by-product of legislation that serves the public interest.

To ascertain whether the capture theory hypothesis can be applied to either the IIROC or the MFDA, we will examine the corporate governance and regulatory frameworks of both organizations bearing in mind the intricacies of regulatory capture.

[14] *Supra* note 9.
[15] *Ibid.*

Section 3: INVESTMENT INDUSTRY REGULATORY ORGANIZATION OF CANADA (IIROC)

3.1 History of IIROC

In June 2008, the Investment Dealers Association of Canada (IDA) and the Market Regulation Services Inc., merged to form IIROC as a not-for-profit corporation.[16] The IIROC's precursor organizations, the IDA and the Market Regulation Services Inc, were formed in 1916 and 2002, respectively. Over the years, the IDA evolved into a decentralized national self-regulatory organization with a dual regulatory and trade association mandate.[17] The IDA subsequently became recognized by provincial regulators as a self-regulatory organization for full-service investment dealers and their registered employees, making registration in the IDA mandatory for firms operating as securities dealers in Canada.[18]

The Market Regulation Services Inc, was created on March 1, 2002, as a joint initiative of TSX Group and the IDA in response to the implementation of National Instrument 21-101 *(Market Operation)* and National Instrument 23-101 *(Trading Rules)*, which required a

[16] Investment Industry Regulatory Organization of Canada (last accessed 10 July 2022), online: https://www.iiroc.ca/about-iiroc/iiroc-faq.

[17] The trade association role was eliminated in 2006, with the creation of a separate and independent trade association called the Investment Industry Association of Canada.

[18] For instance, the OSC recognized the IDA as a self-regulatory organization pursuant to section 16 of the *Ontario Commodities Futures Act*, R.S.O. 1990, c. C.20 and section 21.1 of the *Ontario Securities Act*, R.S.O. 1990, c. S5 on June 15, 1984, and December 14, 1994, respectively.

new neutral entity to regulate trading activities in all Canadian marketplaces, including the Toronto Stock Exchange (TSX).[19]

IIROC currently operates pursuant to Recognition Orders from provincial securities commissions ("Recognition Orders")[20] under the umbrella of the Canadian Securities Administrators (CSA) and is subject to CSA oversight and regular operational reviews.[21] The CSA, which consists of securities regulators in Canada, supervise IIROC to ensure that it meets its public interest responsibilities.

*3.2 **IIROC's Mandate and Responsibilities***

IIROC's scope of authority can be said to be expansive because it functions under Recognition Orders issued by each official provincial securities commission. Widely acknowledged as the mission or purpose of the IIROC is the protection of investors and the maintenance of the integrity of the Canadian capital market. In an effort to fulfil its public interests objective, IIROC is authorized to oversee and supervise its members' or participants' conduct in the markets and in dealing with investors. IIROC, just like its US

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[19] *The Regulation of Marketplaces and Trading,* OSC NI 21-101, (2001) 24 OSCB (Supp). https://www.osc.ca/sites/default/files/pdfs/irps/rule_20010817_alternative_trading_systems.pdf.

[20] Investment Industry Regulatory Organization of Canada (last accessed 10 July 2022) online: <https://www.iiroc.ca/about-iiroc/governance-bylaws>. The CSA comprises securities regulators of Canada's 10 provinces and 3 territories, and the Recognition Orders are granted to IIROC by each of the 13 recognizing regulators.

[21] The recognizing regulators signed a memorandum of understanding (MOU) with IIROC on May 30, 2008, to provide effective oversight of IIROC's execution of its self-regulatory activities and regulation services and to ensure that IIROC is working in line with its public interest mission. On April 1, 2021, the 2008 MOU was updated, restated, and replaced by a new MOU between the recognizing regulators and IIROC.

counterpart, FINRA, is one of the select few SROs that may be labeled "pure SROs" [22], with a mandate to perform extensive regulatory functions.[23]

Specifically, IIROC is empowered to regulate investment dealers, including alternative trading systems (ATSs) and futures commission merchants, among other functions.[24] Investment firms are therefore governed by IIROC Rules[25] which provide rules for dealer member organization and individual approval, business conduct and client accounts, financial and operational rules, dealer member margin requirements and enforcement procedures. The IIROC's Universal Market Integrity Rules (UMIR)[26], which set outs the requirements applicable to participant dealer members for securities-related trading activities, also form part of IIROC's regulatory framework that govern the activities of investment firms. By defining the obligations dealer firms have to their clients, IIROC rules invariably help establish investor rights. Such requirements are intended to underpin IIROC's mandate of preserving investor confidence in the capital markets and reinforce a dealer member's responsibility to uphold high standards of ethics and conduct in their interactions with clients. Indeed, some of these rules appear to be aspirational rather than substantive.[27] For example, IIROC Rules require dealer members to handle clients' businesses "within the bounds of ethical conduct, consistent with just and equitable

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[22] John Carson, "Self-Regulation in Securities Markets" (2011) World Bank, Policy Research Institute Working Paper No 5542 at 10, online: file:///C:/Users/USER/Downloads/SSRN-id1747445.pdf.

[23] *Supra* note 4.

[24] Variation and Restatement of IIROC Recognition Order – Section 144 of the Act and Section 78(1) of the Commodity Futures Act, R.S.O. 1990, c C.20 effective April 1, 2021.

[25] IIROC Rules available at online: https://www.iiroc.ca/media/17141/download?inline.

[26] Investment Industry Regulatory Organization of Canada "UMIR Rules", online: https://www.iiroc.ca/rules-and-enforcement/umir-rules.

[27] Benjamin P. Edwards, "The Dark Side of Self-Regulation" (2016) SSRN Journal, at 584 online: <https://www.ssrn.com/abstract=2829592>.

principles of trade…"[28] The substantive and practical content of this requirement remains vague.

Notwithstanding, the IIROC Rules establish in great detail and explicitly the obligations its members owe their clients, while keeping the clients' best interest as a priority. This does not seem to be the case for the US FINRA rules in which financial advisers are permitted to sell clients "suitable" investments even if they are not necessarily in the client's best interests.[29] The IIROC Rules, on the other hand, require dealer members to recommend investments that are suitable for their clients while prioritizing the client's interests.[30]

IIROC's efforts to safeguard investors and promote healthy capital markets rely heavily on enforcement. This is accomplished through investigating possible infractions and penalizing members who commit such violations. In its 2020-21 Enforcement Report, IIROC explains that in advancing investor confidence in the securities markets, enforcement must be "fair", through thorough investigations and impartial hearing panels; "effective", by sending strong regulatory messages that deter potential wrongdoers; and "timely", by prompt investigation and prosecution of misconduct.[31] It has been posited that financial self-regulatory organizations may be able to effectively enforce if they "keep a

[28] Rule 3102, IIROC Rules, *supra* note 26.
[29] *Supra* note 27.
[30] Rule 3402 (1)(i)(a-e), IIROC Rules, *supra* note 26.
[31]Investment Industry Regulatory Organization of Canada, "Enforcement Report 2020-21" at 2, online: <https://www.iiroc.ca/sites/default/files/2021-07/IIROC_%202020_21_EnforcementReport_en.pdf>.

monopoly and use a credible threat to be able to exclude a participating firm from the cartel as its ultimate enforcement mechanism."[32]

IIROC also maintains a firm grip on industry regulation by routing customer disputes through its arbitration program, should clients opt to use arbitration to resolve their disputes. It does so through supervising the administration of the arbitration processes, but not by conducting the arbitration itself.[33] The participation of a dealer member in, or any decision made under an arbitration program, has no bearing on IIROC's authority or prevents it from exercising its authority in accordance with the IIROC rules.[34] While the arbitrator's decision is final and conclusive, arbitration awards do not create binding precedents and generally do not explain the reasoning behind the decision. It may be impossible to determine the true level of investor protection offered by IIROC's arbitration program, as the standards that apply in IIROC's arbitration are difficult to ascertain.

IIROC can be viewed as a hybrid organization that borrows structural traits from both the public (government) and private (non-profit) sectors — it almost fits into either category.[35] Although it functions as a nominally private, incorporated non-profit, its expanding governmental role in securities regulation cannot be overlooked. As a result, its quasi-

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[32] Jonathan Macey & Caroline Novogrod, "Enforcing Self-Regulatory Organization's Penalties and the Nature of Self-Regulation", (2012) Hofstra Law Review 963 at 966, cited in Benjamin P Edwards, "The Dark Side of Self-Regulation" (2016) SSRN Journal, online: <https://www.ssrn.com/abstract=2829592>.

[33] The ADR Chambers and the Canadian Commercial Arbitration Centre are the designated two independent organizations that conduct arbitrations and also supply independent arbitrators.

[34] Rule 9502 (3) *supra* note 25.

[35] Joseph Mead & Katherine Warren, "Quasi-Governmental Organizations at the Local Level: Publicly-Appointed Directors Leading Nonprofit Organizations" (3 March 2016) online: *Degruyter* https://www.degruyter.com/document/doi/10.1515/npf-2014-0044/html?lang=en.

governmental status allows it to enjoy some of the privileges generally reserved for state actors. For example, some provinces, in strengthening IIROC's enforcement authority, conferred on IIROC statutory immunity from malicious lawsuits while acting in good faith.[36] By charging fees to member firms and operating on a cost-recovery basis, it generates "involuntary" tax revenues.[37] The IIROC Rules also provide IIROC the authority to penalize members who infringe its rules or any relevant securities laws. Despite this, the breadth of its enforcement authority is restricted, and it may only penalize dealer members or regulated persons[38] by reprimand, disgorgement, fine, expulsion, suspension or permanent ban of membership or affiliation, or any other appropriate sanctions.[39] As far as non-members are concerned, it has no authority and cannot impose criminal culpability.

*3.3 **Corporate Governance Framework of IIROC***

The Canada Not-for-Profit Corporations Act,[40] IIROC's By-Law No. 1 (the "By-Laws")[41] and the Recognition Orders establish requirements for IIROC's governance.[42] IIROC's culture and conduct are unquestionably influenced by its governance structure and the

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[36] IIROC Fact Sheet (December 2019), online: <https://www.iiroc.ca/media/14216/download?inline >. Provinces like New Brunswick, Prince Edward Island, Nova Scotia, Quebec and Alberta, through relevant securities legislation, have provided IIROC with the full enforcement toolkit to protect investors.

[37] *Supra* note 25.

[38] Regulated persons mean persons who are or were formerly (i) Dealer Members, (ii) members, users or subscribers of or to Marketplaces for which the Corporation is the regulation services provider, (iii) the respective representatives as designated in the Rules of any of the foregoing, and (iv) other persons subject to the jurisdiction of the Corporation. See IIROC's By-Law 2014, online: <https://www.iiroc.ca/sites/default/files/2021-10/IIROC_GeneralByLaw1_en.pdf>.

[39] Rule 8209 – 8210, *supra* note 25.

[40] S.C. 2009, c.23

[41] IIROC's By-Law, *supra* note 38.

[42] Memorandum from Hansell LLP to Independent Directors of the Investment Industry Regulatory Organization of Canada (31 August 2020), "Capital Markets Modernization Taskforce Consultation Report Proposals re Self-Regulatory Organizations" online: *Hansell* https://www.iiroc.ca/media/12511/download?inline.

voices it empowers. The Recognition Orders require IIROC to periodically examine its corporate governance structure, including its board membership, in order to ensure that the public interest and industry interest are appropriately balanced and effectively represented.[43] IIROC's board members comprise 15 members, with two marketplace directors, five dealer firms directors, seven independent directors[44] and the president. With this composition, one can rightly argue that the IIROC's board is not majorly a public board as the board consists of an equal number of independent directors and non-independent directors.[45] Surely, this raises public interest concerns.

Public representatives must provide something unique to the board that is not already represented by members of the industry, or otherwise their nomination would be pointless. In a perfect world, a public representative would aggressively protect the public's interests while also balancing the influence of the sector on self-regulatory bodies. There must be genuine public-interest orientation and real independence in order to accomplish this aim. IIROC seems to have made some progress in this regard by revising its director requalification requirements to include consumer protection expertise[46] and creating an

[43] *Supra* note 25.

[44] See *supra* note 38. Independent directors are non-official or non-employees of IIROC, who are not linked or affiliated with a dealer director or who is not a registered dealer. This definition does not exactly give some level of comfort or confidence to the public, as it does not ensure complete independence from the industry and representation of investor and consumer interests.

[45] *Supra* note 38. Section 5.2, Article 5 of IIROC's By-Law.

[46] Investment Industry Regulatory Organization of Canada, "IIROC confirms experience with investor issues a critical skill for Board succession" (14 February 2004), online: https://www.iiroc.ca/news-and-publications/notices-and-guidance/iiroc-confirms-experience-investor-issues-critical-skill-board-succession.

investor advisory panel.[47] However, if public representatives have the same viewpoints, attitudes, and prejudices as members of the sector, they may serve the interests of the public with less intensity. Industry-aligned public representatives, (that is, public representatives with previous ties to the industry), at worst, simply create a façade of publicness, masking industry dominance over a supposedly independent board.[48]

While proponents of IIROC's current governance framework may argue that all members of the Corporate Governance Committee must be independent directors, it is important to note that the language of the IIROC's By-laws contemplates that the chair of the committee can also be a non-independent director.[49] Although, IIROC has never had an industry director as chair or member of the Corporate Governance Committee,[50] the fact that IIROC's Bylaws allow for such a situation does not exactly inspire public confidence. There seems to be a lack of transparency and potential for conflicts of interest in the IIROC's governance structure since it appears that an "independent" director may really be from the industry - albeit prior to a cooling-off period. It is conceivable that that their inherent biases, predispositions and continuing industry and social ties may hinder them from being objective. This ultimately casts doubt on the interests of such independent directors, who should not come from the industry in the first place.

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[47] Investment Industry Regulatory Organization of Canada, "New SRO Investor Advisory Panel- Questions & Answers", (last accessed 10 July 2022), online: https://www.iiroc.ca/new-sro-investor-advisory-panel-questions-answers.

[48] *Supra* note 27 at 586.

[49] *Supra* note 38, Section 11.2 IIROC's By-law.

[50] *Supra* note 42 at 4.

But what is the OSC stance on IIROC's corporate governance structure? This is a pertinent question given that the OSC is empowered to, if it is in the public interest, make any decision with respect to any by-law, rule, regulation, policy, procedure, interpretation or practice of IIROC.[51] Practically speaking, IIROC's governance seems to have been overlooked by the OSC to a large extent. At best, its oversight function of IIROC's operation has been limited to its approval of key changes to IIROC's governance structure, among other things, as required under the Recognition Order.[52]

[51] Section 21 (5)(e) of the *Ontario Securities Act* R.S.O. 1990, c. S5.

[52] Appendix A, Section 2 of the OSC Recognition Order, 2021, online: https://www.osc.ca/en/securities-law/orders-rulings-decisions/variation-and-restatement-iiroc-recognition-order-s-144-act-and-s-781-cfa-effective-april-1-2021.

Section 4: MUTUAL FUND DEALERS ASSOCIATION OF CANADA (MFDA)

4.1 History of MFDA

The origin of the MFDA dates back to the late 1980s when the Canadian mutual funds market grew from $40 billion to $400 billion.[53] The rapid bloom of the mutual fund industry necessitated a review of Canada's investment fund industry[54] to verify that regulation was keeping up with market developments, identify any necessary reforms to align industry interests with those of investors, and address industry vulnerabilities. [55] The review was made by Glorianne Stromberg after which she released a report in 1995 entitled *Regulatory Strategies for the Mid-90s: Recommendations for Regulating Investment Funds in Canada* (the "Stromberg Report"). The Stromberg Report was the first major reform initiative in the investment fund industry. Following the release of the Stromberg Report, industry leaders and representatives were invited by the CSA to make recommendations in respect of the Stromberg Report, including those specifically relating to the regulation of mutual fund dealers. One of the CSA's high priorities was the establishment of a national SRO to regulate mutual fund dealers and, potentially, all dealers and distributors of securities or other financial products.

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[53] Mutual Fund Dealers Association of Canada (last accessed 10 July 2022) online: < https://mfda.ca/about/our-history/#:~:text=The%20MFDA%20was%20established%20in,would%20benefit%20from%20more%20effective>.

[54] *Ibid.*

[55] Glorianne Stromberg, "Review of Investment Funds in Canada and Consumer Protection" (1998) online: http://www.sipa.ca/library/SIPAdocs/Stromberg_InvFunds-Oct1998.pdf.

It was recognized that separate self-regulatory structures would likely be required for mutual fund dealers and for securities dealers that handle a wider range of financial products and services. In June 1998, the MFDA was incorporated as non-share corporation. In the same year, the MFDA became formally recognized as a self-regulatory organization by the provincial securities commissions (together, the CSA) pursuant to Recognition Orders.[56] The CSA issued a Recognition Order on the premise that the mutual fund industry and its investors would benefit from more effective regulation and control.[57]

4.2 MFDA's Mandate and Responsibilities

Similar to IIROC, the MFDA has a public interest mandate and is responsible for enforcing regulations, standards of practice and business conduct of its members and their representatives in order to enhance investor protection and public confidence in the Canadian mutual fund industry. The purposes of the MFDA include, but are not limited to:

a. Fostering a high standard of behavior among its members and develop and enforce rules and regulations to maintain such standards in the interests of its members, their clients and the public;
b. Regulating Approved Persons[58] in accordance with its by-laws and rules or as may be permitted by extant securities legislations;

[56] Note that for Quebec, the MFDA operates pursuant to a Co-operative Agreement with the Autorité des marchés financiers and actively participates in the regulation of mutual fund dealers in Quebec.
[57] *Supra* note 53.
[58] This includes members and persons who are or were shareholders, partners, directors, officers, or employees of members or who may be approved by, or attorn to the jurisdiction of the MFDA.

c. Setting membership requirements and approval standards of Approved Persons, monitoring and enforcing compliance with such requirements and imposing disciplinary sanctions for non-compliance;
d. Creating and enforcing by-laws and rules to regulate its business affairs and those of its members and Approved Persons;
e. Investigating, mediating, arbitrating or resolving grievances between the public, members or Approved Persons.

The foregoing description of the MFDA's purpose stresses (perhaps, theoretically) its public interest/investor protection mandate. This it does by monitoring the conduct of its members and the advisors they employ. The MFDA Rules[59] influence investor rights by outlining the obligations and behavior standards that its members owe to their customers. For instance, members and Approved Persons of a member are required to observe high standards of ethics and conduct in the transaction of business.[60] Such member firms or their Approved Persons are precluded from engaging in any business practice that is detrimental to the public interest. [61] Also, in determining the suitability of any investment action taken by a member on behalf of its clients, such action must have been done by placing the client's interests first.[62]

[59] Mutual Fund Dealers Association of Canada Rules (31 December 2021), online: https://mfda.ca/wp-content/uploads/Rules-Dec31_2021-8.pdf
[60] Section 2.1.1(b) MFDA Rules.
[61] Section 2.1.1(c) MFDA Rules.
[62] Section 2.2.6 MFDA Rules.

In accordance with Recognition Orders, the MFDA is authorized to execute certain regulatory functions. Similar to IIROC, its quasi-governmental status enables it to exercise a type of taxation authority via the imposition of fees on member firms. According to its 2021 Annual Report, the MFDA generated $33,816,000 in total revenue, of which $31,537,000 came from membership fees.[63]

MFDA also regulates the behavior of its members via enforcement actions. It explains that "disciplinary actions imposed … are protective and preventative, intended to be exercised to prevent likely future harm."[64] Upon determining that a violation has occurred, the MFDA may initiate disciplinary actions against the member in question. By virtue of its by-law[65], the MFDA, through a hearing panel, may impose sanctions including fines, suspension, permanent prohibition and termination and such other remedial sanctions. The hearing panel usually consists of three regional council representatives, one public representative and two industry representatives. However, such composition demonstrates insufficient public representation in the enforcement process.

To persuade the public that the MFDA is not mainly concerned with the interests of its members or the business as opposed to the public, the panel makeup needs to be reorganized. Between 2019 and 2021, the overall number of hearings gradually decreased

[63] Mutual Fund Dealers Association of Canada Annual Report 2021 at 13, online: https://mfda.ca/mfda-2021-annual-report/pdfs/MFDA_AR_2021_online.pdf.
[64] Mutual Fund Dealers Association of Canada Sanction Guidelines (15 November 2018) at 2, online: https://mfda.ca/wp-content/uploads/MFDA_Sanction_Guidelines_2018-1.pdf.
[65] Section 24, MFDA By-law No. 1, online: https://mfda.ca/wp-content/uploads/By-Law1-May2020.pdf.

from 120 in 2019 to 95 in 2021.[66] Of the 95 hearings, 73 were settlement hearings, while the other 22 were contested/uncontested hearings.[67] In 2020, there were 56 settlement hearings and 21 contested/uncontested hearings.[68] In assessing the appropriate sanctions to be meted out to infringing members, important elements such as the gravity of the charges are considered. A violation involving vulnerable investors, for instance, may be seen as an aggravating element warranting a harsher punishment.[69]

In accordance with its stated objectives, the MFDA also maintains control over industry regulation and the extent of investor protection available by investigating, mediating or resolving grievances between the public, members or Approved Persons. However, unlike IIROC, the MFDA does not have its own venue for alternative dispute resolution where it may route client grievances. Instead, the MFDA requires its members to engage in an ombuds service that has been authorized by the MFDA's board of directors.[70] Clients of its members are also invited to engage in the Ombudsman for Banking Services and Investments (OBSI) dispute settlement procedure in order to resolve investment disputes between member firms and their clients if they are unable to do so themselves. The OBSI can make a non-binding recommendation that the member firm compensates the client for a maximum amount of $350,000.[71]

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[66] MFDA Annual Enforcement Report (2021) at 10, online: https://mfda.ca/wp-content/uploads/EnfAR2021-1.pdf
[67] *Ibid.*
[68] *Ibid*.
[69] *Ibid* at 3.
[70] *Supra* note 65, Section 24.A.1 of the MFDA Rules.
[71] Mutual Fund Dealers Association of Canada (last accessed 10 July 2022) online: https://mfda.ca/investors/.

In the realm of dispute resolution, it seems that the MFDA has little power on industry regulation and investor protection to any significant degree. The non-binding impact of such OBSI-recommended compensation tends to diminish investor trust in such dispute resolution systems. Positively, the MFDA's delegation of the investment dispute resolution service to an independent agency is laudable, since it avoids the risk of any conflicts of interest.`

4.3 Corporate Governance Framework

The goal of good corporate governance is to encourage a sense of trust, openness, and responsibility. These are important for promoting business integrity, financial security, and long-term investments, all of which contribute to economic growth and a more equitable society.[72] From an SRO standpoint, an effective corporate governance system ensures that the management strives to protect the public/investor interests – after all, this is the SROs mandate and the overarching goal of securities regulation. The board of the MFDA consists of 13 members, including 6 public directors, 6 industry directors and the President and CEO. The language of the MFDA by-laws contemplate that the President and CEO cannot be an industry director.[73] Although, the Chair of the board can either be a public or industry director, the board is currently chaired by a public director.

The MFDA's board clearly is dominated by public members, which is laudable, since its public directors appear to have real independence and a genuine public-interest focus. The

[72] OECD, "Corporate Governance" (last accessed 10 July 2022) online: https://www.oecd.org/corporate/.
[73] MFDA by-laws, *supra* note 65. It provides that the industry director means a director who is not a public director or the President and Chief Executive Officer.

appointment of public representatives to the board is based on the notion that they must provide something unique to the board that is not present among the members of the industry. Within SROs, it is ideal that the public interest is maintained and industry power is counterbalanced.[74]

As indicated above, the structure of the MFDA's hearing panel raises public's best interest concerns, as having more industry connections on its enforcement panel may make its members more likely to favor industry defenses. Such enduring business ties may also predispose the hearing panel to empathize with industry problems more readily.

Despite the MFDA's shortcomings in terms of the makeup of its hearing panels, its board composition is unquestionably a step in the right direction towards fulfilling its mandate. Due to the availability of information on the background of its public directors, the MFDA's transparency in this regard cannot be overlooked. A further investigation into the backgrounds of the public directors on the MFDA's board reveals that some of the public directors have extensive industry ties, which may make them more susceptible to business concerns. It is pertinent to note that two current public directors of the MFDA have extensive industry experience. While it may be argued that such directors may actually be completely independent and public-minded, and may even be angered by corporate wrongdoings that tarnish the mutual fund industry, a structure that may potentially give rise to the vulnerability of such industry directors should not be fostered. Thus, the effectiveness of the board should not be contingent on recruiting industry directors who

[74] Benjamin P. Edwards, "The Dark Side of Self-Regulation" (2017), 1117 Scholarly Works at 586 online: UNLV Boyd Law https://scholars.law.unlv.edu/cgi/viewcontent.cgi?article=2141&context=facpub.

are genuinely concerned about public interest. Instead, the board's structure should guarantee that only directors devoted to the public interest serve on it. The eligibility rules of public directors should be modified such that public directors not only have no present ties with industry members, but also have never been affiliated with members.

Section 5: CONFLICT OF INTERESTS

5.1 ***Are the Regulatory Functions and Industry Interests of IIROC and the MFDA Mutually Exclusive?***

Financial markets are getting more and more complicated. In the Canadian securities industry, IIROC and the MFDA have a strong interest and a thorough understanding of both the industry and its regulatory framework. With so many different marketplaces and market participants, having a deep understanding of a narrow niche is very valuable. The rules, standards of conduct, monitoring and enforcement programs established by both SROs rely on a vast network of market experts to contribute real-word expertise.

As a result, both SROs have the experience and direct market contact necessary to keep up with fast industry developments and maintain their regulatory efficacy. Self-regulation has been shown to be an effective kind of regulation and may be characterized as "cooperative regulation" of markets and markets participants.[75] The most controversial aspect of the existing self-regulatory structure is the obvious conflicts between the SROs regulatory functions and their industry interests. In addressing such controversy, we must first acknowledge that self-regulation is reliant on the quasi-governmental or regulatory role of SROs as well as their industry interests or affiliations. The very idea of self-regulation entails the existence of potential conflicts of interests. The IIROC and the MFDA were granted oversight of their respective markets because of their connection to the industry

[75] A review of Self-Regulatory Organizations in the Securities Market before the Committee on Banking, Housing and Urban Affairs, United State Senate (9 March 2006) https://www.govinfo.gov/content/pkg/CHRG-109shrg39621/html/CHRG-109shrg39621.htm.

and technical knowledge. As a result, the purpose is not to eliminate conflicts of interest, but rather to balance them.

How should regulators deal with the inherent conflicts of interest that arise between the SROs' duties to regulate in the public interest and to promote investor protection while at the same time being sensitive to the demands of its members? For the purpose of balancing such conflicting mandates, a number of adequate safeguards or procedures must be maintained. First, IIROC and the MFDA are subject to the oversight of the CSA and/or the provincial securities regulators such as the OSC. These overseeing regulators act as watchdogs to the SROs, "standing in the corner with the well-oiled shotgun".[76] To ensure effective oversight of IIROC's and the MFDA's performances, the Recognizing Regulators and both SROs respectively developed an oversight program which includes: (i) reviewing information filed by IIROC; (ii) reviewing and approving new and amended rules, policies and other similar instruments and by-laws of IIROC; and (iii) performing periodic reviews of IIROC's self-regulatory activities and regulation services.[77]

The second way to manage these potential conflicts is by ensuring a clear cut separation of the functions of the Chairman and the President or CEO. Both SROs separate the role of Chair and CEO. For example, the current chairman of the board of the MFDA is Steven

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[76] *Ibid*.

[77] For IIROC, Section 1(b) of the Memorandum of Understanding Regarding Oversight of Investment Industry Regulatory Organization of Canada, online: https://fcnb.ca/sites/default/files/inline-files/2008-06-01-IIROC-MOU-EN_0.pdf.
(For MFDA) Section 1b of the Memorandum of Understanding Concerning the Oversight of the Mutual Fund Dealers Association of Canada, online: https://www.osc.ca/sites/default/files/2021-03/mou_20130808_concerning-oversight-mfda.pdf.

Glover while the President and CEO is Mark T. Gordon. The IIROC, on the other hand, has as its chairman, Paul D. Allision and its President and CEO, Andrew J. Kriegler. Although, as established above, one shortcoming of the current corporate governance framework of both SROS is that their board of directors is not dominated by independent directors who function as public representatives.

The third way to manage these potential conflicts of interest is through openness or complete disclosure which may be achieved in several ways. Despite the fact that IIROC and the MFDA seem to have lost public trust owing to a perception of their failure to fulfill their public interest mission,[78] they appear to have made substantial efforts in this respect. In order to ensure transparency, both IIROC and the MFDA offer complete, accurate, and timely disclosure of the publishing of annual reports covering the previous year's performance, financial results, compensation of board members and management team, risk, and other significant information. Rules, bylaws, and regulations of IIROC and the MFDA are made accessible to the public in printed or electronic form, and disciplinary actions conducted by both SROs as well as the execution of educational outreach efforts are made public. Throughout the years, IIROC and the MFDA have also engaged the public in the development of regulatory policies and rules.

When it comes to adapting regulations to a constantly changing corporate environment, SROs, like IIROC and the MFDA have more freedom. Most regulatory frameworks include provisions for industry participation and self-regulation. The information and

[78] *Supra* note 8.

institutional background provided by industry participation allows both the identification of trends and the determination of the regulatory consequences of such trends. Emergency circumstances may be handled more swiftly and successfully if industry representation is present.

IIROC and the MFDA have a vested economic, reputational, and regulatory interest in adopting and maintaining best practices and keeping tabs on their respective markets. They are so close to the market and their members that they can tailor their rules and surveillance techniques to the specific characteristics of their markets. The relationship between both SROS and their respective members are contractual and has a powerful reach that statutory authorities cannot achieve. According to IOSCO's Objectives and Principles of Securities Regulation, SROs may mandate the adherence of ethical norms that exceed government rules.[79] The contractual connection also gives greater flexibility and enables IIROC and the MFDA to respond more rapidly, since it is based on both SROs' rules and the members' commitment to comply with their requirements.

With the wide variety of products and marketplaces available to investors in today's competitive market, both SROs will lose revenue if they do not properly regulate their market. This is what makes self-regulation effective. In most cases, an SRO's substantial experience and skills will be more efficient than attempting to replicate it with a statutory regulator. For example, the reaction of core government regulators to market developments are typically delayed due to the bureaucratic restrictions placed on agencies. IOSCO's

[79] *Objectives and Principles of Securities Regulation*, International Organization of Securities Commissions (May 2003) Section 7.2 at 12 online: https://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf.

Objectives and Principles of Securities Regulation accurately emphasizes that SROs may provide more depth and experience about market operations and practices, and may be able to adapt more swiftly and flexibly to changing market circumstances than the government authority.[80] The revision of both SROs contractual agreements (that is, IIROC and the MFDA rules) might be a less laborious procedure than amending statutes via legislative actions.

IIROC and the MFDA have the knowledge, resources, and commitment to assist provincial regulators in investigating issues and developing creative solutions that enhance the health of financial markets and protect consumers. Due to their specialist knowledge, they are able to successfully implement regulatory efforts at a lesser cost.

5.2 ***Applicability of the Capture Theory to IIROC and the MFDA***

The benefits of a well-functioning self-regulation system are several, but so are the risks that, if left unchecked, might overshadow the organization's advantages. These risks stem from SROs inherent conflicts of interest between their regulatory tasks and the interests of their members. Even though these conflicts of interest need not be eradicated but rather balanced, there are still reservations as to whether the public interest mandate of IIROC and the MFDA has been subjugated to industry interests. And so, to what degree, if any, does regulatory capture apply to both SROs?

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[80] *Ibid.*

The widespread consensus is that the SROs' members and the industry as a whole have a disproportionate amount of influence over the policies, priorities, and regulatory initiatives developed by the SROs.[81] The inherent conflicts of interest in self-regulation have not been satisfactorily handled by either the extant regulatory framework or the activities of the SROs over the years. The ratio of industry and independent directors and the absence of a prohibition on an industry director from serving as Chair of either SROs have resulted in ineffective execution of the SROs' public interest mandate, increased the likelihood of conflicts of interest, and dampened investors' confidence and trust in the Canadian capital markets.

Currently, stakeholder participation on IIROC and the MFDA's policy ideas is more limited. In the policy advisory committees and decision-making bodies of both IIROC and the MFDA, for instance, industry representatives have a far larger presence than investor involvement. There is no formal mechanism through which the SROs interact proactively with investor groups in order to guarantee that they acquire objective feedback and commentary on regulatory problems and recommendations.

Enforcement actions taken by the SROs against investment firms or senior executive management of such member firms are very uncommon. The top management of member firms is not held accountable for shortcomings in supervision and compliance processes.

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[81] Fair Canada Comments and Recommendations on CSA Consultation Paper 25-402, "Consultation on the Self-Regulatory Organization Framework" (23 October 2020) at 9, online: https://faircanada.ca/wp-content/uploads/2020/10/2020_10_23_submission_to_CSA_on_SROs_Ver.00.pdf. See also MFDA, "Special Report on Securities Industry Self-Regulation", (February 2020) at 17, online: https://mfda.ca/wp-content/uploads/MFDA_SpecialReport.pdf.

In 2021, only 2 of the 91 proceedings commenced by the MFDA included supervision allegations[82], while 5 of the 27 disciplinary proceedings commenced by IIROC included supervision allegations.[83] As a result, business conduct and investor protections remain substantially unchanged and unimproved. In many instances, decisions about an investment firm and its top management's responsibilities also lack transparency. This covers whether the sufficiency of supervision of dealer representatives (salespeople) was evaluated in the case, as well as any pertinent conclusions.[84]

Even when matters are taken up, the compensation of investors who have been affected as a result of industry malfeasance has not been a priority for the enforcement efforts of either SROs. Both IIROC and the MFDA rules provide for enforcement process that allow the SROs to impose fines and such other sanctions on the firms, but fail to provide for compensation orders for victims, as they do not have the authority to do so. In cases decided by hearing panels or resolved by settlement agreements, not much consideration is given to how the SROs could improve their ability to ensure that firms and dealer representatives provide adequate compensation for the losses suffered by dissatisfied customers.[85] Rarely do notices of decisions on matters involving enforcement include whether the company voluntarily paid the customer for losses. It is also not typical for a company to offer to

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[82] MFDA Annual Enforcement Report (2021) at 9, online: https://mfda.ca/wp-content/uploads/EnfAR2021-1.pdf.

[83] IIROC Enforcement Report 2020-21 at 29, online: https://www.iiroc.ca/sites/default/files/2021-07/IIROC_%202020_21_EnforcementReport_en.pdf.

[84] Fair Canada Comments and Recommendations on CSA Consultation Paper 25-402, "Consultation on the Self-Regulatory Organization Framework" (23 October 2020) at 16, online: https://faircanada.ca/wp-content/uploads/2020/10/2020_10_23_submission_to_CSA_on_SROs_Ver.00.pdf.

[85] *Ibid* at 3.

compensate a customer as part of a settlement agreement reached in connection with an SROs enforcement action; nonetheless, this does happen on occasion.[86]

Owing to the tremendous impact this has on investors, several stakeholders have frequently raised concerns about the significant difficulties investors face when attempting to obtain restitution for losses caused by the wrongdoings of member firms.[87] Investors are forced to depend on complaint procedures that are convoluted, unclear, and time-consuming; an OBSI claims process that does not have the authority to render a judgment that is legally binding; or civil litigation, the expenses of which are often exorbitant for the majority of investors. When it comes to all of these procedures, investment companies have significant advantages over clients in terms of expertise, experience, and the availability of human and financial resources. Because of these significant benefits, businesses have a great deal of ability to settle customer complaints in a way that is favorable to them - provided, of course, that they choose to provide any kind of settlement. At the moment, an excessive number of the SROs disciplinary proceedings result in tiny penalties for failing to perform the responsibilities that are promised to investors, but investors end up swallowing their losses since there are insufficient measures to recover them. From a total of 29 prosecutions in 2021, the total sum of fines, costs and disgorgement payable by both member firms and individuals to IIROC was $2,191,851.[88] For the MFDA, of the 95 hearings concluded by its hearing panel, a total of $4,326,670 in fines was imposed.[89] Since the commencement

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[86] *Ibid* at 16.
[87] *Ibid*.
[88] IIROC Enforcement Report 2020-21 at 30, online: https://www.iiroc.ca/sites/default/files/2021-07/IIROC_%202020_21_EnforcementReport_en.pdf.
[89] MFDA Annual Enforcement Report (2021) at 10, online: https://mfda.ca/wp-content/uploads/EnfAR2021-1.pdf.

of MFDA disciplinary action in 2004, MFDA hearing panels have levied a total of $104,833,117 in fines, of which only $17,087,231 (16%) has been collected.[90] Both IIROC and the MFDA do not have the authority to order payments to investors, as such, fines or disgorgement are only payable to IIROC or the MFDA, as the case may be.

It has been suggested that the SROs prioritize the process of repaying investors who have suffered losses as a result of unethical behavior inside their regulatory enforcement operations.[91] IIROC and the MFDA have also been urged to take a cue from their US counterpart, FINRA, in that its top goal in tackling misconduct is repaying money to aggrieved investors. Through its sanction guidelines and its policy on credit for cooperation in enforcement matters, FINRA also mandates that its adjudicative tribunals and enforcement staff prioritize the compensation of investors for harm caused by member firms. This is in direct opposition to the priority and penalty criteria that have been established by IIROC and the MFDA. The SROs have to revise their rules in order to make it possible for this result to take place. These modifications ought to include regulations on the various punishments and remedies that the SROs are allowed to apply after a hearing or by reaching a settlement.

Access to products and services is one of the many challenges that investors confront when interacting with the current SRO system. Investors are required to manage a client complaints system that is unclear and excessively burdensome, in which they also have

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[90] *Ibid.*

[91] Fair Canada Comments and Recommendations on CSA Consultation Paper 25-402, "Consultation on the Self-Regulatory Organization Framework" (23 October 2020) at 17, online: https://faircanada.ca/wp-content/uploads/2020/10/2020_10_23_submission_to_CSA_on_SROs_Ver.00.pdf.

limited access to appropriate mechanisms to recover compensation for losses caused by industry malpractice. These inefficiencies and impediments entail considerable costs for investors who depend on the regulatory system for protection. Ideally, a centralized platform and procedure for reporting all forms of grievances with investment companies, SROs, and regulators should be made available. The system should be structured such that complaints are automatically sent to the appropriate entity. In addition, all sorts of complaints should be subject to a uniform procedure and service standards that apply uniformly across all firms.[92]

Since the implementation of the present SRO regulatory framework about two decades ago, the delivery of financial services and products has continued to change.[93] Clearly, the present SROs' structure has run its course, since the inherent conflict of interests between the SROs' commitment to their members and their public interest mandates has not been addressed or balanced adequately. As previously stated, the current framework of IIROC and the MFDA in areas such as industry-focused board of directors, lack of formal mechanism to incorporate investor feedback, and ineffective compliance and enforcement practices pose significant challenges, resulting in a decline in public confidence. In other words, the existing regulatory framework for SROs is plagued by a number of flaws or lacunas, making it hard to rule out regulatory capture.

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[92] *Ibid* at 22.

[93] See Introduction of CSA Consultation Paper 25-402- Consultation on the Self-Regulatory Organization Framework, Chapter 6 (25 June 2020), online: https://www.osc.ca/sites/default/files/2021-10/csa_20200625_25-402_consultation-self-regulatory-organization-framework_0.pdf.

Section 6: IMPACT OF THE PROPOSED MERGER OF IIROC AND MFDA ON PUBLIC INTERESTS

Given that IIROC and the MFDA's mandates and regulatory regimes have become so similar over the years, a merger between the two SROs has been long overdue. As alluded to above, the existing regulatory framework of both SROs substantially disadvantages the investing public. This ranges from the SROs' corporate governance structure in which public interests are not adequately reflected, to enforcement actions where compensations awarded by dispute resolutions panels are not binding.

Ahead of the merger of IIROC and the MFDA on January 1, 2023, the CSA released draft documentation in support of the application for recognition of a new SRO, including a draft By-law No. 1 and draft interim rules.[94] The draft new SRO by-law provides an expanded and inexhaustive measures of fulfilling its public interest mandate, including accommodating innovation and ensuring flexibility and responsiveness to the future needs of the evolving capital markets, without compromising investor protection. In addition, the draft interim rules include proposals to (i) amend the current IIROC proficiency requirements to allow dual registered firms to employ mutual fund only licensed persons without having to upgrade their proficiencies to those required of a securities licensed

[94] Canadian Securities Administrators, "CSA Staff Notices related to New SRO and New IPF", (last accessed 10 July 2022) online: https://www.securities-administrators.ca/new-sro/csa-staff-notices-related-to-new-sro-and-new-ipf/.

person, and (ii) permit introducing/carrying broker arrangements between mutual fund dealers and investment dealers.

This is particularly a welcome development considering that the existing structures constraints and limitations are due to the existence of two SROs, with redundant systems. Consider the IIROC rule, for instance, that mutual fund representatives on the IIROC platform wishing to offer securities, including mutual funds, must meet extra education and competence requirements.[95] As it stands, mutual fund dealers are currently not authorized to trade or settle securities other than mutual funds. Neither do investment dealers and mutual fund dealers fall under the same credit and investor protection framework. Due to this structural separation, mutual fund dealers do not have efficient access to the clearing and settlement system via what is known as an "introducing-carrying relationship", with investment dealers.

Even if mutual fund dealers are qualified to do so, this limitation severely restricts the capacity of the majority of mutual fund dealers to distribute to their customers several of the most cost-effective investment products available today, such as the Exchange-Traded Funds (ETFs) and Platform-Traded Funds (PTFs). These increasingly popular and often less expensive portfolio alternatives like ETFs and PTFs are lacking from the MFDA channel. A consequence of this is that mutual fund dealers are unable to efficiently sell these products due to regulatory and operational constraints imposed by the present structure. By combining IIROC and the MFDA into a single entity, access to these major

[95] Section 18.7 IIROC Dealer Member Rule.

product categories for Canadians who are customers of mutual fund dealers would be vastly improved.[96]

Investors are thrown into a loop when various agencies are tasked with overseeing the same kind of product. The industry is unable to fulfill its commitment to investors to be responsive to their diverse demands as a result. With the MFDA and IIROC as part of the same body, member firms would be able to operate their operations effectively, and the new SRO would deploy compliance and supervisory resources proportionally and on a risk-based system. Other components of its mandate will include enabling access to advice and products for investors from diverse demographic backgrounds and managing comprehensive compliance, enforcement, and complaint management and resolution systems.[97]

Investors will find it easier to understand and deal with a more efficient structure as a result of the merger of the two SROs. More than 80% of Canadian investors prefer a "one-stop shop" investing platform, according to a survey conducted by IIROC. [98] An all-inclusive investment experience, on the other hand, would give retail investors access to a wide range of goods and services at a single point of service without the need to create several accounts or sign contracts with multiple entities.

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[96] IIROC, "Improving Self-Regulation for Canadians", (June 2020) at 16, online: <https://www.iiroc.ca/media/13111/download?inline>.

[97] Section 2.1 of the draft by-law of New SRO, online: https://www.securities-administrators.ca/wp-content/uploads/2022/05/03.-Schedule-1-Draft-By-Law-Number-1-of-the-New-SRO.pdf.

[98] Investment Industry Regulatory Organization of Canada, The Strategic Counsel, "Access to Advice" (January 2020), online: <https://www.iiroc.ca/media/7881/download?inline>. The CSA's guiding principles for the New SRO, set out in the CSA Position Paper 25-404 "New Self-Regulatory Organization Framework" (August 2021), reflects a similar focus.

The new SRO's corporate governance structure is likewise notable. The planned board of the new SRO will consist of 15 members, including 8 independent directors, 6 industry directors, and the CEO. The majority public board composition is very commendable and a solid signal of the aim to create a new SRO with a clear public interest mandate, since the different backgrounds and skills of the board members will allow the new SRO to fulfill its purpose. The CEO and board chair responsibilities will be performed by separate persons, with the board chair required to be an independent director. [99]

As to the interim By-law, an independent director cannot have a significant connection with the new SRO or a member of the new SRO, either directly or indirectly. In addition, it gives a more thorough definition of what constitutes a direct or indirect link between an independent director and the new SRO or its member(s).[100] Conflicts of interest involving the organization's executives, directors, and employees, as well as those serving on the SRO's disciplinary panels will be adequately addressed by the new SRO's policies and procedures.

An Investor Advisory Panel (IAP) and an Investor Office will also be established as part of the new SRO's official investor engagement processes. The mandate of the IAP includes "*providing input and advice on investor protection and access to advice initiatives with a view to addressing gaps relating to under-served investors and promoting diversity,*

[99] Appendix A, Application for recognition of the New SRO at 3, online: https://www.securities-administrators.ca/wp-content/uploads/2022/05/02.-Appendix-A-Application-for-recognition-of-the-New-SRO.pdf.
[100] *Supra* note 97 at Section 1.3.

inclusiveness and equity."[101] Having a diversified and geographically dispersed group of people on the IAP's board helps guarantee that the interests of investors are well-represented. This includes areas of competence in the following: investor education, consumer protection/outreach, seniors/vulnerable investors, younger/first time investors, government public policy, et cetera.[102]

Both the IAP and the investor office will offer independent research or feedback on regulatory or public interest concerns, while the investor office will promote rule creation and educate investors. As part of its role, the IAP will provide advice to the new SRO on a variety of topics, including its yearly objectives, long-term goals, policies, and other regulatory efforts. Applicants for the panel will be chosen via a public application procedure run by the new SRO and will be limited to 5 to 11 members. [103] The panel's chair must meet with the new SRO board at least once a year and will write an annual public report for publication on the new SRO's website.[104]

Merging the two SROs would benefit investors, member firms, and the Canadian capital markets as a whole. A smooth transition from relatively basic products and advice to more complicated advisory channels and solutions would be possible for investors as their investing demands evolve. There would be no need to register new accounts or switch firms or advisors if investors' investment requirements change, resulting in less paperwork and

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[101] See New SRO Investor Advisory Panel, Draft Terms of Reference, Schedule 3, Article 1, online: https://www.securities-administrators.ca/wp-content/uploads/2022/05/09.-Schedule-3-Draft-Terms-of-Reference-for-New-SROs-Advisory-Panel.pdf.
[102] *Ibid* at Article 2.3.
[103] *Ibid* at Article 2.2.
[104] *Ibid* at Article 5.

better consolidated reporting for investors. Dealers in mutual funds and investments would be able to streamline their processes and save costs associated with meeting the standards of two distinct regulators. Additionally, the proposed consolidation would give mutual fund dealers more efficient distribution options, particularly with respect to the less expensive portfolio alternatives like ETFs and PTFs. The amalgamation of both SROs will significantly eliminate regulatory redundancy for the Canadian financial markets. The administration of a centralized SRO would provide economies of scale, and improved regulatory efficacy.

Indeed, the proposed regulatory framework of the new SRO provides mutual fund dealers and investment dealers with a significant opportunity to streamline operations and, more importantly, to advance client service and financial solutions, thereby better positioning investors to meet their investment objectives and needs. However, the draft interim rules do come with certain concerns that, if not adequately addressed, might have a negative influence on the proposed regulatory framework, which is intended to emphasize investor protection to foster public trust and to enable innovation and change.

(i) Enhanced CSA Oversight

One of the shortcomings of oversight reviews of the current SROs is that less emphasis is placed on determining whether the SROs are fulfilling their public interest mandate. The language of the draft Memorandum of Understanding (MOU) contemplates enhanced oversight of the CSA over the new SRO and the CSA would also be involved in the new SRO's corporate governance in order to bolster the new SRO's accountability to the

CSA.[105] The draft MOU provides that "*the purpose of the Oversight Program is to ensure that [New SRO] is acting in accordance with its public interest mandate, and complying with the terms and conditions of the [New SRO] Recognition Order*."[106]

While the approach to oversight reviews was enumerated in the draft MOU,[107] it is unclear how the public interest mandate would be assessed, as the approach merely captures the public interest mandate and regulatory responsibilities indirectly by referencing the terms and conditions of the draft Recognition Order.[108]

In evaluating the overall effectiveness of the new SRO, it would be crucial to determine whether the new SRO is successful in delivering strong levels of investor protection and fair outcomes for investors.[109] It is therefore essential to understand how the CSA would assess indications of the new SRO's overall effectiveness in fulfilling its public interest mandate.

(ii) Proficiency Upgrade in relation to Dual-Registered Firms

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[105] CSA, "CSA Position Paper 25-404 – New Self-Regulatory Organization Framework" (August 3, 2021) at 12, *online*: https://www.bcsc.bc.ca/-/media/PWS/New-Resources/Securities-Law/Instruments-and-Policies/Policy-2/25404-CSA-Position-Paper-August-3-2021.pdf.

[106] Section 1, Memorandum of Understanding Regarding Oversight of [New SRO], online: https://www.securities-administrators.ca/wp-content/uploads/2022/05/12.-Appendix-C-Draft-MOU-among-the-Recognizing-Regulators-regarding-oversight-of-the-New-SRO_clean.pdf.

[107] *Ibid* at Appendix B.

[108] FAIR Canada, Fair Canada Comments on CSA Notice 25-304, "Consultation on the Application for Recognition of New Self-Regulatory Organization" (24 June 2022) at 5, online: https://www.osc.ca/sites/default/files/2022-06/com_20220624_25-304_bureaudjp.pdf.

[109] *Ibid* at 6.

Pursuant to the draft interim rules, member firms may be registered as both an investment dealer and a mutual fund dealer. While this is generally a welcome development, it does raise a number of challenges for mutual fund representatives particularly as it relates to proficiency requirements. Under the interim rules, registered representatives of dual registered firms dealing exclusively with mutual funds must complete the Conduct and Practices handbook course within 270 days from the date of their firm's registration as both an investment dealer and mutual fund dealer.[110] This upgrade requirement creates a significant challenge to affiliate firms' efficient structuring without any investor protection justification, in that there would be no change to how MFDA Approved Persons deal with their clients. From a practical perspective, retaining this requirement will create an insurmountable barrier for firms seeking to consolidate.

It is necessary for the CSA to examine incorporating this extra criterion for registered representatives of dual-registered firms that provide exclusively mutual funds. Individual registrants' competency requirements should not be governed by the corporate structure or platform of the dealer. Rather, proficiency criteria should be based on the nature of the activity being undertaken by the individual. Mutual fund dealers should not be obliged to take non-offering-related coursework. This additional obligation, if anything, exacerbates the structural inadequacies of the existing SRO system. It is pertinent to note that a firm registered as an investment dealer but not as a mutual fund dealer may continue to do both types of business under the same legal entity. However, unlike dual-registered firms, the

[110] Rule 2602, Corporation investment Dealer and Partially Consolidated Rules. See also: MFDA, "New Draft SRO Interim Rules – Frequently Asked Questions", (last accessed 29 July 2022), online: https://mfda.ca/new-sro-rules-faq/.

investment dealer will continue to update the proficiencies of their mutual funds-only licenced persons to those necessary for securities-dealing individuals. Notwithstanding, to impose this requirement as a condition of becoming a dual-registered firm when the nature of the mutual fund business for these registered representatives does not change, and when MFDA continuing education rules continue to apply to dealers who do not choose to become dual-registered firms, is inconsistent and will impede transition. Existing representatives who deal only with mutual funds should not be compelled to "requalify" just because IIROC and the MFDA have merged.

(iii) Introducing/Carrying Arrangement

The proposed modifications to Rule 1.1.6 of the MFDA Rules[111] would allow introducing/carrying broker arrangements between mutual fund dealers and investment dealers. As noted above, expanding customer access to ETFs for mutual fund dealers is a desirable endeavour, and allowing such agreements would enable mutual fund dealers to avoid the costly and inefficient workarounds now required to support distribution of ETFs.

However, the proposed amendment would require a mutual fund dealer to comply with the investment dealer rules if the carried business is significant.[112]

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[111] Draft Interim Rules of the New SRO: Mutual Fund Dealer Rules, online: https://www.securities-administrators.ca/wp-content/uploads/2022/05/06.-iii.-Mutual-Fund-Dealer-Rules.pdf.

[112] *Ibid* at Rule 1.1.6(c)(ii).
Various considerations (such as the economic worth of the carried business or the proportion of the mutual fund dealer member's entire business that is represented by the carried business) would be considered when determining what is significant. These variables will be assessed in connection with related matters such as the mutual fund dealer member's company and business strategy.

In such circumstances, mutual fund dealers would be subject to investment dealer rules, including those pertaining to capital, margin, insurance, handling client cash, client reporting, and segregation of client cash and securities, simply by virtue of being carried by an investment dealer, as the nature of their mutual fund business has not changed. It is important to highlight that the proposed requirement would prevent mutual fund dealers, especially smaller dealers, from taking use of the proposed introducing/carrying broker flexibility owing to the high costs and complexity of the shift from mutual fund dealer to investment dealer rules. If this condition is maintained, the CSA would not accomplish its intended result of enhancing access to advice and products such as ETFs for customers of MFDA member firms. Therefore, mutual fund dealers should have direct market access to trade ETFs.[113]

(iv) Transition Period

The CSA's proposal to adopt and implement the interim rules which incorporate pre-merger regulatory requirements from the IIROC and MFDA Rules and Bylaws is praiseworthy. However, the CSA's proposal is vague on whether there would be a transition time before the new SRO becomes fully operative. Even though the merger is scheduled to begin on January 1, 2023, an effective transition of both SROs is questionable. The CSA's proposal does not include any transitional grace periods for updating client-facing disclosures, paperwork, and signs to reflect the names and emblems of the unnamed SRO. To guarantee smooth transitions with no duplication of labour or expenditures, which would eventually be perplexing for all parties involved, it is necessary to establish precise timetables

[113] This will be effected pursuant to a blanket exemption to National Instrument 23-103 – Electronic Trading and Direct Electronic Access to Marketplaces.

Section 7: CONCLUSION

Self-regulation should not be confused with self-interest. Conflicts of interest have always posed the greatest threat to self-regulation. Every regulatory agency, whether it be a statutory regulator or an SRO, is susceptible to pressure from the industries that they oversee. It is not always the case that a statutory regulator is more resistant to pressure from the outside than an SRO. In order to guarantee that SROs adhere to professional norms of conduct, the compliance processes that SROs use have to be open and responsive to the public.

Indeed, the proposed merger of both SROs is a positive step, since the proposed rules and by-laws of the new SRO aim to restore public confidence and trust in the integrity and effectiveness of the securities regulatory regime. The CSA's efforts to establish a new SRO and a framework for efficient and effective regulation, including the harmonization of rules governing existing mutual fund and investment dealers, are very noteworthy. This Article recommends that the new SRO should prioritize the investor's perspective and experience when creating its platform. Complaint handling should be better improved to serve investors. The processing of complaints has to be enhanced so that it can better serve investors. This might be accomplished by developing a uniform web platform for all complaints, which investors would be able to use in order to make complaints on any sort of investment. Complaints should be filtered via the portal and sent to the appropriate SROs, regulators, or marketplaces. The industry and regulators should find out the most effective way to route complaints to the appropriate organization. A centralized complaint

process advising service would be essential, and should include a website with clear step-by-step directions to submitting a complaint, video tutorials (which may be shared on social media), a frequently asked questions section, and access to counsel by automated response, phone, or chat. Further, compensating victims of misconduct should be a central tenet of the new SRO's enforcement and complaint-handling and resolution process. The new SRO regime should also prioritize how it can better ensure firms and dealer representatives provide fair compensation for losses of aggrieved clients in cases decided by hearing panels and cases resolved by a settlement agreement. Furthermore, given the limitations of disgorgement orders, the new SRO should obtain the authority to order compensation for losses caused by misconduct where disgorgement alone is not relevant or is insufficient to compensate for the losses incurred.

In conclusion, it is essential to note that the strengthened supervisory role of the CSA envisioned in the new SRO regime is a step in the right direction, given that the merging of both SROs would result in a larger, more powerful SRO. The CSA must be a vigilant and ardent watchdog of the new SRO. With this approach, it will be possible to rein in the excesses of the new SRO and guarantee that the interests of the investing public are constantly prioritized. As such, when designing and implanting the public interest changes in the new SRO regulatory regime, due attention must be given to investor protection.

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