Kenmar Associates
Investor Education and Protection

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Request for Comment on Proposed MFDA Sanction Guidelines
http://mfda.ca/bulletin/bulletin0749-p/

Kenmar Associates is an Ontario- based privately-funded organization focused on investment fund investor education via on-line research papers hosted at www.canadianfundwatch.com . Kenmar also publishes ***the Fund OBSERVER*** on a monthly basis discussing investor protection issues primarily for investment fund investors. An affiliate, Kenmar Portfolio Analytics, assists, on a no-charge basis, abused investors and/or their counsel in filing investor complaints and restitution claims.

Kenmar appreciates the opportunity to respond to this Mutual Fund Dealers Association of Canada consultation request. We are told that Sanction Guidelines are intended to promote consistency, fairness and transparency by providing a framework to guide the exercise of discretion in determining sanctions in MFDA disciplinary proceedings.It is our understanding that Sanction Guidelines are designed to assist the MFDA and Respondents in conducting disciplinary proceedings and in definitizing responsible settlement agreements, as well as MFDA Hearing Panels in the fair and efficient administration of sanctions in settled or contested disciplinary proceedings.

A sanction should aim to change the behaviour of the offender, aim to eliminate any financial gain or benefit from non-compliance, be responsive and consider what is appropriate for the particular offender and regulatory issue, be proportionate to the nature of the offence and the harm caused, aim to restore the harm caused by regulatory non-compliance, when applicable, and aim to deter future noncompliance.

Sanctions are one tool intended to improve specific and general deterrence and hence to protect mutual fund investors. Since our background is systems oriented we find it virtually impossible to comment on sanction guidelines as if they were not part of an integrated regulatory system. Accordingly, where there is a close relationship between sanction guidelines and other parts of the regulatory system, we take the opportunity to provide comment.

The new Guidelines do away with the minimum fine requirements and/or prescribed fine ranges set out under the previous sanction guidelines in favour of a principle-driven approach. The $5 million cap per violation remains intact. Fines collected go into a Discretionary (Restricted) fund See APPENDIX I

Kenmar are pleased to see the MFDA consider client compensation as an explicit element in the proposed guidelines. We are also glad to see that the MFDA seems to have identified disgorgement as a Sanction tool. It should officially become a discrete sanction tool. We hope that, if adopted, all disgorgement dollars will be returned to the victimized client.

The Consultation paper does not identify the risks and issues resulting from a conversion to principles-based sanctions. Some possible risks and issues include:

(a) Variability in fines in time or by region as a result of open-ended fine structure
(b) Increased need for senior management support of compliance function
(c) Perception by investors that sanctions are wrist slap
(d) Inability of academia, investors, media to benchmark the appropriateness of fines and sanctions
(e) Lack of a fundamental fairness principle such as the one utilized by OBSI
(f) The toxic combination of a foggy suitability standard coupled with ill-defined monetary sanctions could lead to confusion/erratic enforcement.

Putting aside our concerns, the transition to principles-based sanctions guidelines is an opportunity to make some improvements in the overall sanctions regime. There is at least the possibility of more creative and contemporary sanction practices. We respect the MFDA for opening this discussion.

Research suggests that whether or not principles based or rules based compliance is effective depends on the broader context; in particular, the incentive structure that the Member has for compliance or non-compliance and an attitude towards the regulatory regime. Poor recommendations and bad advice are not the result of a few bad apples in the system, but from compensation structures and firm wide practices that place Members' and representatives' interests ahead of the interests of clients. Based on MFDA findings, compensation conflicts are a major issue in the mutual fund industry.

Preamble

The mutual fund industry while portraying itself as an industry focussed on providing trusted personalized advice , is in fact riddled with conflicts-of -interest at all levels and entity boundaries . This applies at the fund level right through the distribution system. The MFDA has published **Review of Compensation, Incentives and Conflicts-of-Interest** http://mfda.ca/wp-content/uploads/Bulletin0705-C_2.pdf) regarding distribution. There is also the fundamental conflict of embedded commissions and dealers selling only proprietary products but claiming to provide trusted personalized investment advice.

A Jan. 2017 Report (http://www.osc.gov.on.ca/documents/en/Securities-Category8/sn_20170110_81-408_consultation-discontinuing-embedded-commissions.pdf) by Professor Douglas Cumming detailed the adverse impact these compensation and

proprietary product sales conflicts have on investor savings. These conflicts impinge on the Sanction guidelines which in turn tie back to enforcement. Until the CSA is willing to deal with these conflicts, the MFDA will be constrained in the actions it can take and investors will pay the price, no matter what sanctions regime is in force.

NI81-105 **Mutual fund Sales practices** is a core piece of regulation related to the provision of personalized financial advice (previously referred to as distribution). If this Instrument is robustly enforced, this should prevent much mis-selling giving rise to fewer breaches requiring sanctions. It is no secret that NI81-105 issued in 1998 has not been enforced by any regulator until very recently.

The emphasis of sanctions has historically been on breaches by individuals related to suitability, account churning, leveraging, KYC adulteration and unauthorized trading. It is our view that a primary driver of these investor abuses was the dealer compensation system that violated NI81-105 provisions. Once the MFDA enforce this Instrument, the nature and target of the sanctions should change dramatically. For one, the emphasis will be on the dealers who have designed compensation systems to skew salesperson recommendations.

The MFDA, like other regulators, has in our opinion, too often sanctioned these breaches as acts by individuals despite the fact that the root causes were often compensation related. The compensation schemes are designed by Member firms to increase fund sales. See Root Causes APPENDIX II

Introduction

In 2017, the MFDA completed its first proceeding against a Member firm by any Canadian securities regulator addressing sales incentives, marketing and educational practices under1998's National Instrument 81-105. It is clear the MFDA is stepping up its game, albeit late.

Mutual funds account for 31% of Canadians' financial wealth and are owned by 4.9 million households. As of February 28, 2018, the MFDA had 91 Member firms. These Members represent approximately $5457.51 billion of mutual fund assets under administration and are the sponsors of approximately 80,192 mutual fund sales persons. so the guidelines will have a major impact on Main Street. The need for a robust sanctioning process is amplified now that several provinces have granted the powers to the MFDA to collect fines via the courts.

According to the 2017 MFDA Enforcement Report, 469 cases were opened, 217 case assessment files were referred to Investigations, 151 investigation files were referred to Enforcement, Enforcement concluded 133 Hearings and 121 Proceedings commenced. In 2017, 184 Cautionary and Warning letters were issued, down from 206 in 2016. The degree of specific or general deterrence effected by such letters is unknown to us. The amount of fines imposed in 2017 amounted to just $8.5 million, a small fraction of the

harm done to investors in the $1.48 trillion mutual fund industry. This is why the proposed MFDA sanction guidelines have attracted so much investor attention.

Investor protection has three core elements 1. Prevention of exploitation; 2. Deterrence by sanctions and other means and 3. Investor restitution when things go off the rails. Investor protection means protecting investors against undue financial and non-financial harm resulting from wrongdoing ,misrepresentation, overcharging (wrong account type, wrong class/ series sold and failure to provide appropriate price breakpoint) , negligence , lack of proficiency, errors/carelessness or defective processes and control /compliance systems .Victims of financial assault are more interested in compensation than the fines imposed on wrongdoers. To the extent that the sanction guidelines can address element #3. , it is to that extent retail investors will feel protected and trust in the industry increased.

Accordingly, key success indicators include (a) the degree to which sanctioned Respondents are held accountable for investor losses/rule breaches (b) the number of cases actually investigated and prosecuted. If the percentage of complaints investigated is reasonable, investors would have every reason to feel assured and (c) the extent to which clients are made whole.

Credible deterrence is a key component of any effective enforcement strategy. Deterrence is credible when would be wrongdoers perceive that the risks of engaging in misconduct outweigh the rewards and non-compliant attitudes and behaviours are discouraged. Deterrence occurs when persons who are contemplating engaging in misconduct are dissuaded from doing so because they have a high expectation of detection and that detection will be rigorously investigated, vigorously prosecuted and dealt with via robust and proportionate sanctions.

That being said, we question the MFDA characterization of general deterrence "*General deterrence may be achieved if a sanction strikes an appropriate balance between a Respondent's specific misconduct and industry expectations as to an appropriate sanction to be imposed* ". It should NOT be related solely to industry expectations. A balance must also be struck with the key stakeholder- the investor, the customer, the victim.

In our view "***General deterrence"*** refers to inducing others tempted to commit this offence not to do so. It is especially important with violations involving premeditation or planning and persistence. Sanctioning refers, in part, to convincing the public that the violation in question is serious, one which respectable people would shun, and not technical or minor. It also reassures Canadians and informs everyone that the relationship between rule violations and punishment is considered, logical, and fair. The point we want to make is that it should not be a balance involving only industry expectations, which some consider shamefully low .It should also be seen by the Public and investors in particular as fair, appropriate, timely and effective at preventing recurrence among other Members or Approved Persons.

Enforcement plays in important role in deterring misconduct and thereby promotes public confidence, consumer protection and market integrity. Other regulatory activities that can deter misconduct in a credible way, include strong and resilient regulatory governance, comprehensive enforcement powers, good regulatory practices such as timeliness of enforcement intervention, a fair complaint handling system and the use of new technologies and techniques that innovative regulators can apply to deter misconduct.

The proposed guidelines are to be used in disciplinary hearings and settlement negotiations to help determine appropriate penalties for rule violations. The proposed guidelines would replace the MFDA's existing guidance in this area. The Consultation paper says the proposals, "reflect industry trends away from recommended fine amounts and penalties for specific violations … and toward a principles-based approach to sanctioning," Against that background, the proposed sanction guidelines, "are intended to promote consistency, fairness and transparency by providing a framework to guide the exercise of discretion in determining sanctions which meet the general sanctioning objectives." No details are provided on this industry trend or why the current sanction system needs to be changed. It would be useful if such evidence were provided.

It is ironic that the mutual fund industry opposes the Best interest standard because of a lack of specificity and both dealers and fund manufacturers are demanding hard numbers regarding promotional spending limits -See *Mutual fund firms concerned with lack of guidance on promotional spending* | Investment Executive https://www.investmentexecutive.com/news/products/mutual-fund-firms-concerned-with-lack-of-guidance-on-promotional-spending/ The industry tormented OBSI Re comprehensive disclosure and detail on its loss calculation methodology ,a disclosure it does not provide when dealing with retail investor complaints. Even IIROC is now proposing fixed dollar fines for minor violations. We wonder how the fund industry will react to a sanction regime proposal based entirely on principles with no numeric signposts.

We do not understand how a guideline with no dollar numbers or dollar ranges can lead to consistency of application by Hearing Panels. We were only able to check two other SRO's. FINRA [See *FINRA Manual - Archive - Sanction Guidelines [Version up to May. 1, 2018] - General Principles Applicable to All Sanction Determinations [Version up to May. 1, 2018]*
5. Where appropriate to remediate misconduct, Adjudicators should order restitution and/or rescission
http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9199]
, which does use numbers in conjunction with application principles and IIROC which is 100% principles-based.

Our experience with IIROC Settlements consistency is far from reassuring. We have provided numerous examples in papers and in the Fund OBSERVER. Canada's provincial

securities Commissions do utilize a principles-based approach albeit with a fair degree of critical commentary coming from investor advocates and internationally.

A recent empirical Research Report by Mark Lokanan on IIROC*, Enforcement Funnel Study*, presented the following Findings:

- The findings indicate that while IIROC funneled in more complaints, a significant proportion of complaints were funneled out of its enforcement system and funneled away from the criminal justice system.
- Fines imposed were often not collected for individual offenders.
- IIROC, it seems is ineffective in handling the more serious and systematic industry problems.
- The share of investigation's completed seems to be decreasing with time possibly because they were funneled out at the complaint stage.
- Considering IIROC's claim that it takes complaint handling seriously, the data shows that the number of complaints shrink significantly from the initial complaints to investigations and then to prosecutions from 13,793 through 1767 investigations finally ending up with 457 in prosecutions (3% of the total).
- IIROC's enforcement department funnel away about 9% of cases involving criminal elements- misappropriation of funds, forgery and fraud, cases that should 'have been referred to the criminal justice system for criminal prosecution.
- The main financial sanction imposed on both individuals and firms was fines. The total amount of fines imposed is much higher than the amount of costs and disgorgements.
- When firms are concerned, the share of cost is on average around 9%, while disgorgement was only present in 2013 when it amounted 12% of the total number of financial sanctions imposed.
- IIROC seems to be going after individual offenders more vigorously, rather than the root cause of the problem, the member firms.
- There is a strong positive correlation between average fines and cost indicating that IIROC's hearing Panels may impose harsher fines for investigations that are costly. Firm fines imposed pale in comparison to the $5 million in fines that can be imposed – the fines imposed on disciplined individuals and member firms were $103,000 and $383,000 respectively on average per decision.
- Other findings included Most common type of complaint is Suitability issues; Suitability, inappropriate financial dealings, misrepresentation, discretionary and unauthorized trading made up 58% of all individual complaints and Average amount of fines collected per case is $16.5 K.

The study suffers from a few limitations. First, the paper only looks at data that were initially assessed by IIROC from various sources and made their way through its enforcement system. Cases where firms under-reported complaints to COMSET or chose to deal with them internally is missing from the analysis. Second, the paper only deals with cases that came to the attention of IIROC's case assessment team and are considered regulatory matters, which in effect limits the referral sent through to enforcement. Nevertheless, the study points to numerous issues the MFDA should not

ignore in establishing sanctions guidelines (a copy of the study has been provided to the MFDA under separate cover).

We are unclear as to exactly how the new sanction guidelines will improve fairness and proportionality in decision-making. In any event, fairness and proportionality must be assessed not simply vis-à-vis the Member or individual who was sanctioned but also vis-à-vis the investors on the integrity and fairness of our markets as a result of losses incurred or other harms that result from the wrongdoing.

Kenmar fail to understand how the guidelines will act as a deterrent in the absence of legal certainty, a key IOSCO deterrence criterion, regarding the scope and range of financial sanctions. It may well be that empirical research does validate the principles-based sanctions approach but we were not able to locate it.

Some thoughts on fines as the core sanction

The proposed sanction guidelines articulate some of the considerations that could act as mitigating /aggravating factors. For example, if a Member agrees to provide compensation, this would be taken into account when determining the magnitude of the sanction (usually a fine) on the Member firm. That is a positive but inadequate approach to investor protection, at least as we have defined it.

In conduct cases where there has been widespread, significant, and identifiable customer harm or the Respondent has retained substantial ill-gotten gains, the MFDA generally should require (not just consider as a mitigating factor) the payment of restitution and disgorgement and also pursue the collection of any fine.

Kenmar recommend that the sanction guidelines provide generic criteria for trading off investor compensation vs. fines and move away from fines being the default sanction against which there are mitigating and aggravating factors. This approach has the benefit of maintaining both deterrence AND investor restitution. Since it is our firm conviction that Members are responsible and accountable for the actions of their Representatives, this approach is only applicable to Member cases. We further recommend that Members be responsible for the fines of individual Approved Persons if reasonable attempts at collection have failed.

Such an approach will certainly attract Member attention. Kenmar believe this approach would ultimately lead to fewer instances of investor abuse and would help to reduce the need for fine revenue to subsidize MFDA Hearing Panels and other operations. Such an approach would result in fewer Member cases going to OBSI, lower operating costs for the Ombudsman and thus less need for Member fees to operate OBSI. With less effort required for fine collection, more resources could be applied to other more important issues facing the MFDA. Finally, our proposed approach would be hugely positive for vulnerable investors and seniors. They would avoid the stressful, convoluted, time consuming and adversarial investment industry complaint process that plagues the

investment industry's current complaint resolution process .Ultimately, such a progressive approach could improve the fund industry's compliance culture which is a Win-Win for all stakeholders. We recommend that the MFDA adopt this more investor-centric approach to sanctions.

Specific Comments and Recommendations

The primary goal of securities regulation is investor protection. Disciplinary sanctions are protective and preventative, intended to deter harm, not as a punishment. An effective / fair complaint handling system is essential for clients and the public at large to have trust and confidence in the advice industry. Putting all these ideas together we are pleased to make the following recommendations to the MFDA in its role as a Public interest regulator.

#1 Factor number 2 *Industry Expectations* As previously mentioned, the expectations of the Public must also be considered. It should not be forgotten that the mutual fund industry has blocked, delayed or watered down investor protection reforms for twenty years. With some notable exceptions, the industry has clung to the embedded commission model to the detriment of investors. It is our firm conviction that it is the public's expectations that must be met, not just those of the industry. We strongly recommend that the MFDA add Societal and Investor Expectations. This will give more credibility to the MFDA as a trusted SRO.

Societal and investor expectations If a sanction is less than what Canadian society and investors would reasonably expect for the misconduct under consideration, it would undermine the goals of the disciplinary process. It would also diminish its deterrent value and further harm the reputation of the $1.48 Trillion mutual fund industry. Any sanction imposed should be proportionate to the conduct and the impact of the Conduct at issue. The sanction should reflect the relevant aggravating and non-generic mitigating factors. In particular, financial assault on vulnerable investors and seniors should be accorded the highest level of sanctions.

#2 Amend Factor 3. *The seriousness of the allegations proved against the Respondent* to include securities regulations, not just MFDA By-Laws, Rules and Policies. This would then capture such regulations as NI81-105 Mutual Fund Sales Practices.

A breach of securities regulations must by definition be considered as serious. The Consultation Paper states *"Deception – Attempts by the Respondent to conceal his or her misconduct or to lull into inactivity, mislead, deceive or intimidate an investor, the Member or regulatory authorities, should be considered an aggravating factor."* under Factor 3. We do not see deception as solely an aggravating factor, we see it as a fundamental investor abuse in its own right. Kenmar therefore believe that the wording should be changed to Deception – *Attempts by the Respondent to conceal his , her or its misconduct or to lull into inactivity, mislead, misrepresent , deceive or intimidate an investor, the Member , OBSI or regulatory authorities, shall be considered a breach of*

securities law .- a failure to deal fairly, honestly and in good faith . Deception is evidence of Failure to Cooperate which is one-of the most serious infractions by a registrant or Member Firm. The item should be listed as a discrete Sanction Factor in the guidelines as well as an aggravating factor in Settlements. See SIPA paper **Web of Deception** http://sipa.ca/library/SIPAsubmissions/WEBofDECEPTION_2017.pdf

#3 11. *Previous decisions made in similar circumstances*
Hearing Panels should consider previous decisions made in similar circumstances. The amount of a fine or other sanction depends on the facts of each case, including the need for specific and general deterrence. While prior decisions are instructive, the nature and extent of the sanction to be imposed will depend on the facts of the case.
We suggest Adding: When Hearing Panels deviate substantially from jurisprudence, the reasoning shall be articulated in the Panel Decision.

#4 We recommend changing Factor
12. For multiple violations, the total or cumulative sanction should appropriately reflect the totality of the misconduct to**:**
Depending on the facts of the case, the existence of multiple or similar violations may be treated as an aggravating factor and may warrant higher sanctions. The non-linearity principle should be considered where there are multiple violations; the overall impact on the Investor is worse than a linear accounting of each breach. (an example might be improper leveraging and unsuitable investments. The investor might lose money as a result but the combination of the two branches might also result in the loss of a home.)

#5 We have a problem with inability to pay as a Factor. Sanctions must be viewed as fair and consistent in order to be accepted by victims of financial assault, investors and society at large. In practical terms it would require considerable MFDA staff time, effort and expertise to credibly validate a Respondent's inability to pay. We see no redeeming value of such a consideration in a Sanction Guideline for the mutual fund industry.

#6 We firmly believe that internal Member discipline should not take the place of the public enforcement process. However, we do believe that the MFDA should take into consideration certain actions a Member has taken internally when considering how the MFDA would address a violation .By doing so, members would be encouraged to take appropriate timely and effective action internally and ultimately lead to cultural change. Member sanctions already levied such as demotion, increased supervision and termination should be considered. Since we believe internal "fines" or requests for the Approved Person to compensate investors are in breach of provincial labour laws, we exclude such sanctions from consideration. The fact that the Member has issued the Rep a Cautionary letter should not preclude the MFDA from also issuing such a letter. Sanctions imposed by a Member are not transparent to the public, so transparency is lost.

#7 Kenmar recommend that disgorgement be formally recognized as a distinct sanction. When used, disgorgement should be an isolable sanction and not be consolidated into a

fine. The amount disgorged as a result of an improper transaction shall be the TOTAL amount wrongfully earned as a result of that transaction, not just that portion received by the Respondent.

#8 Transparency of proceedings promotes public understanding of the legal and regulatory framework's that govern behaviour and financial services regulation and is another mechanism that may influence behaviour in a positive way. The ability of the public and media to observe proceedings is therefore an important aspect of the regulatory system that can deter misconduct and promote confidence in the system. Kenmar recommend that the Hearing Panels which are convened to determine if settlement agreements are reasonable and in the public interest should be open to the public in order to ensure transparency and accountability. Ref The Yale Law Journal - Forum: **Securities Settlements in the Shadows**
https://www.yalelawjournal.org/forum/securities-settlements-in-the-shadows

#9 We recommend that the MFDA establish mechanisms that would make it relatively easy for investors to submit Victim Impact Statements. Such Statements can have a sobering effect on wrongdoers and potential wrongdoers.

#10 While it may not appear to be immediately related, we firmly believe that the MFDA's bold expanded cost reporting proposals, if implemented, will deter mis-selling. The increased cost visibility will lead to more fruitful client-Rep discussions before purchase decisions are made. It may also uncover dealer IT system /internal control deficiencies. We recommend that the MFDA pursue this initiative. An ounce of prevention is worth at least a pound of cure. See **50 million more reasons for CRM2 – Episode 4**
https://www.steadyhand.com/industry/2016/12/21/fifty_million_more_reasons_for_crm2/

Recommended additional Factors

We recommend the following additions to the list of key sanction Factors:

Dealer accountability. Dealers are to be held accountable for the actions of their representatives. This is in accordance with client expectations when they engage an MFDA registered firm, open an account with a Member firm and G20 High Level Principles of Financial Consumer Protection para 6 to which Canada is a signatory. In essence , in any case where the Member systems, compliance monitoring , supervisory practices , recruitment protocols, Approved person training program , Approved person appraisals, and compensation scheme is the root cause of the MFDA rule breach, the dealer shall be held responsible and accountable. The contract is between the customer and the Member firm. The contract is not between the customer and any of its employees/agents. All responsibility for any Rep negligence or wrongdoing is for the Member to subsequently assess and resolve, consistent with applicable laws. This is not to say that in some cases like OBA or Off Book, that the salesperson should also not be held accountable. See more on Root Cause APPENDIX II.

Exploitive Complaint handling If a Member's Complaint handling process is not designed and implemented to provide a fair and timely assessment and compensation of a client's complaint this deficiency is significant. This would include low-ball offers and rejection of OBSI restitution recommendations. Deficient complaint handling could also be an aggravating factor in certain cases.

"Fair and timely handling of client complaints is a fundamental requirement for MFDA Members, both at the time of receipt and during the OBSI dispute resolution process" - Mark Gordon, President and CEO of the MFDA. https://www.securities-administrators.ca/aboutcsa.aspx?id=1635

Kenmar recommend that the MFDA take steps to ensure that breaches by Members of their regulatory obligations in the complaint reporting and complaint handling process, including their obligations at 0BSI, are appropriately subject to disciplinary measures that are meaningful, timely, provide specific and general deterrence and are made public. We acknowledge that the MFDA has taken a leadership position in prosecuting exploitive industry complaint systems.

The MFDA must ensure that Members are adhering to CSA Staff Notice 31-351 and MFDA Bulletin #0736 – M .MFDA Policy 3 must be amended to conform with National Instrument 31 -103 to require Members to provide a substantive response to a complaint within 90 calendar days, whether they use a second review process (an internal "ombudsman") or not. Within the 90 days, members may choose to provide a second level of review. However, they should not be permitted to take more than 90 days in total to provide a substantive (binding) response. [under separate cover we have provided the MFDA with a comprehensive Commentary on MFDA Policy 3]

Unlawful conduct this would be considered the most severe type of misconduct. This would include but not be limited to key document adulteration (e.g. KYC), signature forgery, theft, Off- Book Sales, acts of fraud and gross negligence amounting to fraud. It should be made clear to Members and Approved Persons that all such cases will always be referred to law enforcement. Kenmar are aware that police do not have the resources or make it a priority to investigate white collar crime. That is a separate issue that regulators and elected officials must deal with. Kenmar believes that enhanced MFDA tracking and reporting of the prevalence and incidence of wrongdoing such as fraud and other financial abuse complaints, investigations and proceedings is of importance. Law enforcement and other bodies will be more likely to dedicate resources to these issues when there is objective evidence demonstrating how prevalent they are and how much such unlawful conduct impacts victims financially, emotionally and physically.

Notification of Clients There should be a requirement that the Member provide every client of a disciplined registrant with a copy of the MFDA News Release announcing the enforcement action findings. This would strengthen investor protection, allowing clients to verify if they have also been a victim. It would also be a major deterrent to the

Dealing representative and Member firm.

SUPPORTING INFRASTRUCTURE

Sanctions that are certain and predictable, and allow Approved Persons and members to foresee, and be held accountable for, the consequences of their actions can deter misconduct. Rules and sanction guidelines should be written, interpreted and applied in a way that fosters consistency, so that Approved Persons and members can understand the laws and rules that apply to them, readily foresee the consequences of their actions and organize their practices and behaviour in a way that complies with the applicable rules and laws. When sanctions are open ended, we therefore question how the use of only broad principles can satisfy this basic criterion.

The failure to comply with obligations may sometimes arise due to insufficient awareness of the rules/sanctions and their application. The regulated community should know the regulatory and legal frameworks that apply to them, understand regulatory expectations of behaviour and be able to see clear and consistent regulation of obligations and tangible consequences for noncompliance with those obligations and other misconduct.

If this Guideline is approved it should be accompanied with a robust user manual/Guidance. Approved persons and Members should receive appropriate training, have real-time access to the rules and sanction guidelines and receive periodic updates and refreshers as applicable

Also required are a training course for Panel Members (including an element on Root cause analysis) and a historical database. The database would include an easily searchable database for use by MFDA staff and Hearing Panel Members that would include case numbers (web-linked), type of infraction, the Sanction(s) imposed and a Remarks column. This would permit Panel's to better manage consistency of Sanction application, one of our key concerns. We recommend that the database go back at least three years prior to implementing of the new Guidelines for continuity purposes.

We recommend that all Settlement Agreements should clearly state whether or not the Member made the client whole. This transparency would be welcomed by investors, Investor advocates and Member firms with high ethical standards. Merely requiring such disclosure would have a positive impact on deterrence and Investor protection. There is no justification for secrecy. In any event, if the Member does make the client whole and it is a factor in determining the nature and size of sanction, this should be explicitly revealed in the documented Settlement agreement and Hearing Panel decisions.

It is also our conviction that an OBSI, one with binding recommendation powers, would be a powerful deterrent force. Members would know that clients would have access to free, robust, fair and determinative complaint resolution and this in turn should motivate them to avoid complaints or at least settle them amicably and promptly. Prevention of

complaints is a far better method of achieving investor protection and Member compliance than dealing with complaints after Investor harm has been occurred. . According to the 2016 Battell Report, 18% of OBSI recommendations were rejected or low-balled, $41K on average. We recommend that the MFDA as a JRC Member advocate for OBSI to have binding recommendation authority.

We fully support the MFDA's determined effort in entering into disciplinary information sharing agreements with provincial insurance regulators, IIROC and the FCAC. We believe that this will be much more effective re deterrence than diversion of resources to fine collections on individuals. It will deter and discourage regulatory arbitrage by dual-licensed Reps. See *Regulatory arbitrage impairs investor protection* http://www.canadianfundwatch.com/2014/07/regulatory-arbitrage-impairs-investor.html and APPENDX III.

The MFDA Whistleblowing program should be reviewed and updated as applicable to improve its effectiveness as a deterrence and detection tool. Kenmar encourage the MFDA to publish an annual report on its whistleblower program. The report could indicate the number of tips received in the year and since inception, the number of investigations that have been opened or have been materially assisted by tips and the number of proceedings commenced (and concluded). Such information should assist with the awareness of the Whistleblower program, increase the number of tips and thereby add to deterrence.

Conclusion

Kenmar are constructively critical of a move to a 100% principled-based sanctions regime. We see some risks and some benefits. The new approach appears to create the scope for a new era of investor –centric sanctions.

We have identified a few issues where the investor should be prioritized over that of the investment industry. The primary objective of the MFDA is investor protection/the Public interest and other interests should therefore be subordinated to that objective in Sanction Guidelines and sanctioning principles.

Regulators who communicate their objectives, mandates and outcomes enhance the deterrent impact of enforcement activities. Public messages send a clear signal as to what behaviour is unacceptable and thereby help to set and raise industry conduct standards and investor confidence.

We believe a deeper root cause analysis will result in more dealer prosecutions and increased emphasis on client compensation will lead to big improvements in deterrence.

Kenmar take this opportunity to again request the establishment of a funded investor advisory panel along the lines of the OSC IAP. The period ahead is one of dramatic change - ETF's, Alt funds, regulatory change, a transition to fee-based accounts, senior demographics, technological change and a possible change in the sanctions regime.

There has never been a rime where such a Panel is needed to ensure that the MFDA is deeply engaged with investors. It is our understanding that the IAP has been very successful for the OSC. We have no doubt that the MFDA would benefit in a similar manner. It should be noted that FINRA, a U.S. SRO has had an Investor Issues Committee for some time. The MFDA as a recognized thought leader, should welcome such a Panel.

Dealing with Rule breaches is a necessary but incomplete action for robust securities regulation and investor protection. Kenmar is of the view that current sanction practices need something more. We believe it is rooted in a culture change at Member firms. This can be achieved by the MFDA focussing on creating a culture of compliance. See *A Call for Sentencing Reform in Ontario Securities Regulation: Restorative Justice, Pyramids and Ladders* by D. Ho University of Toronto
https://tspace.library.utoronto.ca/bitstream/1807/33295/3/Lo_Daniel__201211_LLM_thesis.pdf

We sincerely hope that this investor/investor advocate perspective is useful to the MFDA in improving sanction guidelines and their impact on investor protection.

Do not hesitate to contact us if there are any questions regarding our submission.

Permission is granted for public posting of this document.

Sincerely,

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Advisor bans stir controversy (lack of consistency a huge issue)
"Some advisors are telling WP they don't understand the discrepancy in IIROC panel decisions they point to a $2.9 million loss for several clients associated with the advisor IIROC was prepared to let go without a suspension. The advisor that was handed a five-year ban managed a client's portfolio worth $2 million. IIROC is now addressing those concerns, telling WP it can't comment on specific enforcement cases or decisions, but there are guidelines in place which provide a framework for determining sanctions. The specifics of which IIROC determines on a case-by-case basis."
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[IIROC] Advisor bans stir controversy
"Some advisors are telling WP they don't understand the discrepancy in IIROC panel decisions they point to a $2.9 million loss for several clients associated with the advisor IIROC was prepared to let go without a suspension. The advisor that was handed a five-year ban managed a client's portfolio worth $2 million. IIROC is now addressing those concerns, telling WP it can't comment on specific enforcement cases or decisions, but there are guidelines in place which provide a framework for determining sanctions. The specifics of which IIROC determines on a case-by-case basis."
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https://www.investmentexecutive.com/news/from-the-regulators/iiroc-settlement-with-former-rep-inadequate/

APPENDIX I: A Note on the Discretionary (Restricted) Fund

The discretionary fund was established for the collection of fines and payments made under settlement agreements and may be used by the MFDA for limited purposes. Money from fines and settlements is contributed to the MFDA 's Discretionary Fund, which the MFDA uses to finance reasonable costs associated with the administration of MFDA's Hearing panels, capital expenditures necessary to address emerging regulatory issues, projects relating to investor and industry education, and other uses authorized under MFDA's Recognition Orders. The key point to note is that monies collected from fines helps subsidize MFDA operations - not one cent is used to compensate victims.

We note that a recent CSA Oversight Review of IIROC revealed that written requests to IIROC management regarding the use of the restricted funds were inadequate and lacked certain required information, resulting in a risk that management may make an incorrect decision in respect of the use of the restricted funds. To address this gap in procedure, IIROC amended its Restricted Fund Policy to require that written requests for funding must specifically describe how a proposed project complies with the rules governing the use of the restricted fund. We urge the MFDA to do likewise but to go further. We expect a better public accounting of the application of funds and a scope expansion that would permit the fund to finance independent empirical Investor research suggested by consumer groups and investor advocates. The reporting can be in the form of a separate Annual report and/ or in a defined section of the Annual Report. Per the 2017 Annual Report, this fund holds in excess of $2.5 million. Furthermore, as fine collection improves using newly granted collection powers, the fund should increase in value.

APPENDIX II: Root Cause Analysis and Sanctions Regime

Over the past few years we've been analyzing MFDA Settlement Agreements. In many cases it appears to us that the symptom is being treated but the real disease remains untreated. For example, if Members use a sales quota scheme, then one should not be surprised if aggressive selling takes place since job security could be at stake. Similarly, if a Member has a non-linear commission grid those funds with higher payouts will likely attract more attention from salespersons. The tales of DSC fund churning are well

documented going back to the Stromberg reports. In these cases, the salesperson is sanctioned but is the salesperson not a victim of the system rather than the culprit? In our view, the root cause of mutual fund mis-selling is dominated by perverse sales incentives rather than Black Hat salespersons. The MFDA needs to motivate its Members to review and revise their business models and incentive structure to deter mis-selling. Until the system is changed, the MFDA should step up its prosecution of dealers.

Another example of Root Cause analysis involves supervisory issues. The purpose of a supervisor is to ensure that Approved persons comply with all applicable policies, rules and laws. So when we see cases where mis-selling has occurred over an extended period of time, we conclude the root cause of the mis-selling is either systemic or lax supervision. In some cases, supervisors may have commission over-rides that put them in a conflict-of-interest. Therefore, we conclude that while the Approved Person is the tip of the iceberg, what lurks below is the real source of the problem – either the underlying systemic structure or weak supervision. If the systemic structure or the supervisor had acted promptly, all or much of the mis-selling could have been avoided. In all such cases, deficient dealer supervision should also be subject to sanctions.

In some cases we have been involved in at OBSI, we have discovered that the salesperson was not motivated by greed. In one case, after a few interrogatories, it became clear to us that the salespersons really did not understand how ROC Funds work. inadequate Member training was the root cause of the flawed advice. In other cases, salespersons were unable to explain how they constructed the portfolio. In such cases we fault the low educational standards in place by regulators as the root cause. These standards were established years ago before the industry repositioned itself as trusted wealth Advisors rather than salespersons. In fact, NI31-103 eliminated the term "salesperson "and replaced it with a less revealing moniker, Dealing representative. In practice, regulators permitted the use of the term "Advisor" which in effect, misleads clients. We are aware that one of the targeted reforms deals with salesperson proficiency. When the advice giver is a true professional holding a CFP designation, the Rep would also be held accountable.

Conversely, in the controversial double-billing scandal no-contest settlements, system deficiencies were blamed for Dealer over-charging that took place for over a decade. While we remain skeptical that that was truly the root cause, if we do accept that reasoning, than again we find that it was dealer system deficiencies and not the misbehaviour of individual "Advisors". That it took a decade to uncover this pillaging (estimated at $350 million) of investor accounts is a black mark on regulators as much as it is on dealers. Given that it appears that the industry is shifting to fee-based accounts, the MFDA investigation practices will need to make adjustments and the application of sanctions reconsidered. See ***Are no-contest settlements in the public interest?*** https://www.theglobeandmail.com/report-on-business/rob-commentary/are-no-contest-settlements-in-the-public-interest/article35735938/

Suitability is often cited as the number one cause of customer complaints. A major

reason for unsuitable investments can often be traced to deficient risk profiling. According to a 2015 PlanPlus research study 83% of risk assessment questionnaires in use are unfit for purpose. So what may appear to be unsuitable recommendations may in fact be due to inadequate dealer risk profiling tools provided to salespersons. The MFDA has also provided valuable guidance on risk profiling. It is not known to what degree industry participants have picked up on that guidance but from where we sit, it is not very high. A related problem is the CSA approved mutual fund risk rating system based on the industry lobbyist IFIC model. Since it is based solely on historical SD, it can mislead salespersons as to the real risk involved in the fund at the time of sale. Investigators must take these factors into account when determining the applicable sanctions.

A good example of the challenges the MFDA faces is the issue of signed blank forms. This is a very serious issue since it undermines the KYC process, the foundation of the Advice process. The MFDA has been diligent in prosecuting this breach with limited success. One could conclude that the sanctions are inadequate but it can be a sign that MFDA rules need to be updated or that Member training is inadequate or that the industry needs to change its recruitment standards. This is why we continue to stress Root cause analysis in investigations and in complaint handling. Settlement Agreements should always be subjected to Root Cause analysis. See Root Cause Analysis https://des.wa.gov/services/risk-management/about-risk-management/enterprise-risk-management/root-cause-analysis

In a very recent case (http://mfda.ca/notice-of-hearing/noh201727/) we find an example of an entire branch gone rogue without corporate detection. In that case the MFDA held a hearing on May 25 to determine penalties for 12 former Reps at a Mississauga, Ont. branch of WFG Securities Inc. who were found to have falsified KYC information in order to qualify them for investment loans. At a disciplinary Hearing held on May 16 and May 17, an MFDA hearing panel found that multiple allegations set out in a Feb. 28 notice of hearing were proven, and that the reps violated MFDA rules. The respondents violated MFDA rules as part of a "widespread practice at the branch, which involved falsifying, fabricating or altering clients' KYC information ... in order to obtain investment loans to purchase mutual funds in client accounts," the MFDA stated in the notice of hearing. Yes, the Reps did that but who hired this gang of wrongdoers, who incented them by giving them commissions for those leveraged sales, and who was willfully blind to all this wrongdoing? - the dealer. So the targets and media attention are the Reps but this fiasco needn't have happened at all if dealer supervision and compliance systems had done their jobs. Hopefully, the MFDA will pursue the dealer and will include investor compensation as either an aggravating or mitigating factor depending on how the Member treated the victims.

Bottom line : Deeper root cause analysis will result in addressing the underlying causes of rule breaches and this in turn will result in material improvements in deterrence and industry culture .

APPENDIX III: A NOTE on Fine collection from Individuals

Given the other much more important regulatory challenges a priority on fine collection seems misplaced. This collection effort will likely lead to a diversion of scarce resources from compliance / enforcement with little deterrence value and zero investor compensation. Rather than enhancing investor protection, however, these powers appear to be transforming the role of SROs more into something resembling public prosecutors, without significant consideration or public debate of the implications. We're not alone in questioning this priority. See **Investment watchdogs have been asking for far too much power — and Ottawa just gave it to them** https://webmail.bell.net/appsuite/#!&app=io.ox/mail/detail&folder=default0/INBOX&id=187933 and **Manitoba Joins Emerging Trend of Granting More Legal Authority to Investment Industry Regulators, but is Investor Protection Really the Bottom Line?** http://www.babinbessnerspry.com/blog/more-legal-authority-to-industry-regulators.html?utm_source=Mondaq&utm_medium=syndication&utm_campaign=View-Original and **IIROC shouldn't have court authority to collect fines: lawyer |** http://www.advisor.ca/news/industry-news/iiroc-shouldnt-have-court-authority-to-collect-fines-lawyer-233715 Kenmar encourage the MFDA to focus on the prosecution of dealers ,address the core issue of compensation conflicts in order to dramatically improve deterrence and investor protection and selectively redirect resources applied to fine collection from individuals.

The OSC has utilized its no-contest settlement process to put to bed a series of high-profile cases against some of the industry's largest players without undergoing contested hearings – all the while ensuring that hundreds of millions of dollars are returned to investors who have been wronged through systematic overcharging and other industry misconduct. The negative media publicity and compelled Investor restitution we believe do provide some measure of deterrence. Not ideal, but a reasoned tradeoff compromise in certain types of cases.

Where there has been no widespread customer harm, and individuals are barred or suspended, the MFDA should consider foregoing the imposition of a fine and instead require that any order of client restitution or disgorgement be satisfied upon the individual's re-entry into the securities industry. (including as an IIROC or other registrant) .The goal here is to (a) prioritize investor protection/compensation above fine collection, (b) not unduly divert precious MFDA resources on fine collection and (c) improve trust in the regulatory system.