OPINION

Securities regulation is based on presumptions, misconceptions and often outright myth

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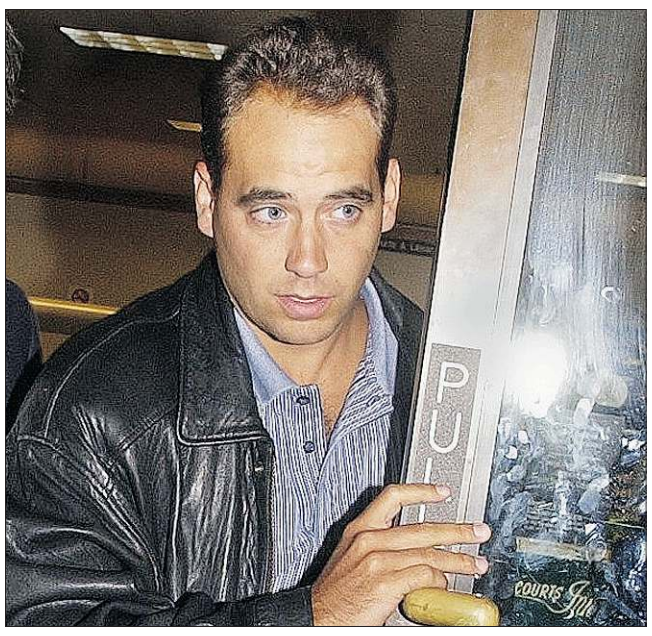

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The Ponzi scheme run by Eron Mortgage Corp. principals Brian Slobogian (left) and Frank Biller mimicked actual returns in the B.C. real estate market.

Vancouver Sun columnist David Baines recently gave a presentation to a sub-branch of the B.C. Bar Association, entitled The Myths of Securities Regulation. This column is excerpted from that presentation.

The first "myth" — perhaps more of a misconception — is that certain investments are "too good to be true." This is often stated as a self-evident fact, which should have been clear at the time of investment.

But is it? Eron Mortgage Corp. investors were offered the opportunity to invest in syndicated mortgages that were said to be perfectly safe and would yield returns of 15 to 21 per cent per annum. Was this too good to be true? Anybody who has invested in Vancouver-area real estate knows that property prices can increase by that amount in a single year. Is that too good to be true? Definitely not. And keep in mind, Eron's story was that this money was going to fund builders' mortgages, which usually command higher returns.

Smart promoters always piggyback on real-life situations. When uranium is increasing by double digits, they promote uranium deals. Ditto for gold, oil, or what have you. Consider also that in many of these schemes, the promoters actually pay out, at least initially. The Eron promoters paid out year after year after year. These are often long-playing confidence schemes that give every sign of legitimacy.

More generally, our system encourages people to have confidence in the capital markets. After all, we have an act of the legislature, the B.C. Securities Act, which prescribes proper market conduct. We have an entire government agency, the B.C. Securities Commission, which is designed to enforce proper securities conduct. There is also the Investment Industry Regulatory Organization of Canada and the Mutual Fund Dealers Association of Canada, which are presumed to be imposing law and order on the street. We also have the RCMP Integrated Market Enforcement Team, a huge RCMP commercial crime division in Surrey and the Vancouver Financial Crimes Unit. The average investor doesn't understand their limitations. All they have is a vague understanding that somebody is looking out for their interests.

The upshot is that when a debacle like Eron Mortgage comes along, there are two quite different responses. The chattering classes say investors should have known better. Investors say, if this investment was too good to be true, why didn't all the king's men and all the king's horses shut it down?

Another myth is that people who fall for these schemes are greedy, which is why they overlook all these obvious warning signs (which, as we have noted, are not always that obvious). I have met hundreds of victims over the years, and few have struck me as inherently greedy. They are, for the most part, people who are anxious about their future and their children's future. A study of the Eron victims showed most were past middle age, ill-prepared for retirement, and looking for a way to catch up.

It is, of course, much easier for us to impute some sort of greed factor, and dismiss these victims as the authors of their own misfortune. It provides the comfort of causality: These people ignored the caveats, so they pay the price. It makes us feel safer. We are not driven to change the system.

This attitude has, in so many subtle ways, shaped our regulatory system. For example, the cornerstone of the public markets is full, true, plain and timely disclosure. The assumption here is that, given proper information, investors will make prudent decisions. Problem is, the average investor will never read a prospectus, an offering memorandum, or even a financial statement.

Our system implicitly recognizes that many people cannot be left to their own devices. They need help. So the general rule is that issuing companies cannot sell securities unless they file a prospectus outlining all salient details of the investment, and the person selling the investment must be registered as a salesperson or securities adviser. The registrant, in turn, must know the investment, know their client and ensure that the investment is suitable for the client. If he or she screws up, the registrant's firm can be held vicariously responsible.

But there are many exemptions to these prospectus and registration requirements. These exemptions, in my view, ignore the basic vulnerabilities of investors. For example, the commission has decreed that anybody can sell anything to anybody in any amount as long as they provide the investor with an offering memorandum and the investor signs a risk acknowledgment statement.

The underlying assumption is that, if you get the basic information about the company, and you acknowledge that you can lose all your money, then you must bear responsibility for what happens. That may sound reasonable to some, but for most people, this provides little or no protection, and in fact, creates an environment in which predators can prosper.

What we see over and over again are ruthless sales agents who are not licensed in any capacity, have no professional training, and are paid commissions of seven, 10, 12 and in some cases 15 per cent to sell investments that are doomed to fail.

The irony is that these investments are so complex and risky that investors need more, not less protection. Yet they get far less protection than the person who is, for example, buying 100 shares of a senior corporation like Telus Corp.

Regulators in most other provinces recognize this. Last year, the Canadian Securities Administrators — the umbrella organization for provincial regulators — devised a national policy that would require people who sell these sorts of exempt products to be registered as exempt market dealers. This would require them to know the investment, know their client and adhere to suitability requirements, and their firms would also be subject to auditing and compliance reviews.

But a strange thing happened on the way to the forum. B.C. and the three other western provinces decided to opt out of this national policy. Why? B.C. regulators argue that the exempt market is too large, and the amount of misconduct too small, to warrant this extra layer of regulation. I say the risk to the public is too great not to provide this additional protection.

Another exemption to prospectus and registration requirements, also based on a myth, is the so-called sophisticated investor exemption. The assumption here is that people who have a certain income and net worth do not need the protection of a prospectus and registration. But the electrician who runs his own business and develops it into a profitable enterprise doesn't necessarily know a thing about securities investments. Same with doctors, engineers and all kinds of people who have a large income and high net worth.

The Gallowai Bul River fiasco drives this point home. Calgary promoter Ross Stanfield, now deceased, raised $229 million over 30 years, from nearly 4,000 sophisticated investors in Alberta and B.C. for an exploration project near Cranbrook. He repeatedly told investors he had hit the motherlode, but never produced a thing. There is plenty of evidence that assay results and resource estimates were fabricated. If this deal had been subject to prospectus and registration requirements, it would have been curtailed much earlier.

That leads us to another myth – the myth of legal remedy. A significant segment of securities regulation revolves around the right of investors to sue. For example, there are deemed reliance provisions: An investor does not have to prove he read and relied on a prospectus to sue for any misrepresentations that might have been in that prospectus. The Securities Act deems that he did, so he doesn't have to prove it when he goes to court.

But so what? Who can afford to go to court? And to what end? The promoters are usually judgment-proof. And you can't sue regulators for failing to regulate, unless you prove they acted negligently. Eron victims found this out the hard way after they launched a class-action lawsuit against the B.C. superintendent of mortgage brokers on grounds that he failed to properly regulate the firm.

Also, courts are tricky places to obtain redress. Dissident shareholders of Gallowai Bul River launched a minority shareholder oppression petition against Stanfield in B.C. Supreme Court, spent over $1 million showing how he had abused them, and yet lost the case.

So it's a real no man's land out there. It would be one thing if there was no regulation, then people would understand they are truly on their own. But what we have is a little regulation, enough to instil confidence and induce investment, but not enough to protect investors from unscrupulous sales agents and promoters.

I think we all realize — especially after the 2008 financial meltdown — that regulation is a good and necessary thing. For our capitalist system to survive, we have to impose an effective system of checks and balances. The so-called self-correcting elements of capitalism simply leave too much blood on the floor.

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