IN THE MATTER OF
THE SECURITIES ACT, 1988, S.S. 1988, C. S-42.2

AND

IN THE MATTER OF
SCOTIA SECURITIES INC.

D E C I S I O N

Hearing Held June 12, 1991

Before: Marcel de la Gorgendiere, Q.C. Chairman
Herbert Dow, Vice Chairman
Morley Meiklejohn, Commission Member
Rand Flynn, Commission Member

Appearances: James Hall representing Commission staff
Laurance J. Yakimowski representing
Scotia Securities Inc.

Decision dated July 3, 1991

DECISION

The Notice of Hearing stated its purpose was to firstly determine whether it is in the public interest to register Scotia Securities Inc. ("Scotia") as a securities dealer pursuant to Section 27 of The Securities Act, 1988, S.S. 1988, c. S-42.2 (the "Act") when Scotia does not participate in the Canadian Investor Protection Fund ("CIPF") as required by Saskatchewan Local Policy 3.6. ("The Policy"). Additionally, in the event that Scotia was to be registered without participating in CIPF then what terms, conditions and restrictions should be imposed, if any?

The Commission considers this application of fundamental importance to investor protection in the operation of the Canadian securities industry. There is then a question of principle involved and as often is the case in such situations there is no disagreement as to the facts but rather only an argument as to the effect of the stated facts. The undisputed enumeration of the actual situation in the Notice of Hearing shows that Scotia proposes to carry on business in the Province of Saskatchewan as a discount broker, selling a variety of products including options and would be trading in the secondary market, operating margin accounts and holding clients' free credit balances and using those funds in its business operation and retaining client securities.

Scotia does not belong to any of the approved self-regulatory organizations which require membership in the CIPF and proposes to enter into an arrangement with the Commission to have a "guarantee" provided by its parent corporation the Bank of Nova Scotia (the "Bank") which would guarantee Scotia's net free capital requirement as required by the Act or Regulations. The ‘guarantee' would also state that it would provide the same level of protection as would be available to customers of a member firm under the CIPF. There was no precise statement of all the details of or the nature and effect of the guarantee and whether the similar written ‘guarantee' of the President of the Bank provided to the Chief of Securities Administration in Alberta was enforceable in the form given. Several interesting points of corporate law were raised as well as points made about guarantee requirements.

The Commission does not find it necessary to come to a decision on any of the technicalities of the ‘guarantee'. For the purpose of its decision the Commission was satisfied that it would be possible to provide a binding guarantee on behalf of the Bank and that the Bank had substantial capital available to meet any likely draw as a result of its commitment. It presumed that the details of any default to be covered could be worked out as was done with the CIPF. We further agreed that the Bank's internal auditing procedures were of a high standard. The question remains, however, is it in the public interest to agree to such an arrangement contrary to the provisions established in the Policy?

To make that consideration it is necessary to look at the reasons

for the Policy. As the Policy itself states, it was established to set out restrictions that will apply to registration of security dealers who do not participate in the CIPF. The CIPF established by the members of the Investment Dealers Association of Canada and the Canadian stock exchanges was to firstly set various capital and auditing provisions which would attempt to prevent a loss of customers' funds in the case of an insolvency. Secondly, in the event that they failed to do so to provide a fund that would be a source of payment to compensate customers of an insolvent firm. CIPF and its predecessor the National Contingency Fund have been operated by the self-regulatory organizations ("SROs") formed by Canadian security dealers for a number of years.

It is obvious that the capital requirements and audit provisions as well as the nature of any protection fund are an ongoing matter which must be reviewed by securities administrators in the light of changing operating conditions. Accordingly, the Policy indicates the Canadian Securities Administrators established a National Regulatory Working Group (NRWG) which contained both regulatory and industry personnel and the working group prepared a report to the Canadian Securities Administrators in December of 1989 followed in March, 1991 by a draft set of regulatory provisions. They stated the draft was an attempt to provide for "the financial health, competitiveness, and stability of the securities market" by a "proposed framework [that] would require all registrants exposed to similar risks to meet similar capital audit and financial reporting requirements --- the proposed classification system reflects the type of business conducted by registrants and is based primarily on the extent to which they have access to customer funds and securities". They went on to make recommendations as to classes of dealers and advisors and related capital financial reporting, insurance, compliance, and audit requirements. In regard to principal and agency business they made the following recommendation: "these registrants are exposed to the widest range of risk due to direct holding (i.e. as a depository) and handling of client assets (e.g. ability to use client cash and margin securities to finance security firm business). As a result, the NRWG considers that registrants in this class pose the greatest risk to clients and other firms within the dealer credit ring and accordingly the most stringent regulatory requirements should apply to this group including customer protection by the Canadian Investor Protection Fund ("CIPF"). They should also be subject to continuous regulatory oversight".

These recommendations were accepted by the Canadian Securities Administrators, including Saskatchewan, however it was recognized that in some cases statutory and regulatory changes would have to be made before these requirements were enforceable nationally. Given that such a process may result in some changes, but that the situation warranted immediate action, the Saskatchewan Securities Commission accepted the recommendation of its staff that there was

a need to make provisions in regard to the operation of securities dealers registered pursuant to the regulations under the Saskatchewan Securities Act who did not participate in the CIPF. There were three small provincial securities dealers registered whose operations were limited and the conditions for their operation without membership could be established by a local policy. We could do this immediately because we were empowered to do so by our recently enacted Securities Act and Regulations. The provisions within the Policy would not be compatible with operations which Scotia desires to carry on. Scotia is therefore, in effect, requesting that the securities dealer restrictions established by the Policy do not apply to it and that the Commission accept the Bank's standards in lieu of those imposed by being a member of a self regulatory organization and to substitute the Bank's guarantee for that of belonging to the CIPF.

Part of the argument of the Applicant was that as a discount broker as contrasted to a full service broker there would not be the same degree of risk, as the activities of a full service broker are more extensive than that which they will carry on. However, Mr. Bruce Dickson in giving evidence on behalf of Scotia admitted that the term discount broker was not a term defined in any regulation, but rather one that was well known by custom within the trade. It involves usually, taking orders without giving advice. However, the Commission notes that even if it was to accept the possibility of issuing a restricted securities dealer licence in which only those conditions commonly accepted under discount brokering would be allowed that such an arrangement would still involve Scotia in handling clients' assets and there was no question that Scotia would also have the ability to use client cash and margin securities to finance firm business. These are the aspects of concern to the NRWG in establishing the category that among other things, required the controls established by belonging to a self-regulatory agency and the CIPF.

The two main arguments advanced by the Applicant were that with the requirements imposed on Scotia having to do its selling and buying through Scotia McLeod Inc. another Bank subsidiary and being audited by the Bank, it would meet or exceed all the control requirements that would ever be imposed through a membership in an S.R.O.. The Commission finds that as laudable and astute as the Bank's internal examiners might be, that such a system has unacceptable attributes to an entity constituted for the purpose of attempting to protect the investors' interest as the Saskatchewan Securities Commission sees itself. It accepts the evidence of Mr. Donald A. Leslie, F.C.A., President of the CIPF, a distinguished chartered accountant with a record of involvement in insolvency operations throughout his career with Clarkson Gordon prior to being involved in his present position. That evidence suggested that "although it might be argued that the inspection department of a parent bank can carry out competent periodic inspections, such work is not equivalent to the work carried out

by the SRO system. Bank examiners see only one firm in the course of their work. They are not familiar with the development of the rules and the intent of each rule. Further they are not independent of the ownership of the registrant. It would not in my opinion be prudent for a provincial securities commission to rely solely on the inspection department of the parent bank for the assurance that it obtains from the SRO system".

The Commission further relies on the evidence given by Gregory M. Clarke of the Investment Dealers Association of Canada as to the difficulty in accepting a guarantee in lieu of the backing of assets in a fund as there is no direct way of checking the guarantor. As he stated: "if you are not regulating the institution, you lack the requisite knowledge of it".

Questions were raised by the staff of the Commission as to the internal difficulties that would be faced by the Commission in assuming responsibility for supervising and controlling the operations of Scotia if it were not an SRO member. The Commission agrees that it would be obligated to substitute itself for the review and requirements of an SRO. It does not accept that this cost should be assumed by the Commission to the benefit of the Applicant when its competitors pay that cost by self assessment through their SROS. However, all of the concerns expressed and difficulties suggested are not going to be reviewed during the course of this decision because the Commission is convinced that the application is not in the public interest because of the effect of such application on the operation of the CIPF.

The Commission accepts the evidence of Messrs. Leslie and Clarke that allowing the continued operation of Scotia without it being a member of the CIPF could have the inevitable effect of allowing every subsidiary of every financial organization capable of providing a guarantee such as offered by the Bank to withdraw from membership in the CIPF. It will then create an unlevel playing field for the smaller firms who would still be required to pay the expenses of supporting a fund while competing with other firms not bearing the same expense. It would probably in the end have the competitive effect of driving out of business smaller firms and certainly make it extremely difficult to establish new firms. Such a lack of competition would not be in the public interest.

The Commission feels that it would not be in the public interest to accept the principle that there is some point where the size of a financial institution ensures there is no possibility of failure and therefore no need to participate in protection funds. This particular argument, if accepted, could be used to attack the membership requirements for major banks in the CDIC or for major insurance companies to not participate in the funds set up for the protection of investor losses as a result of the failure of an insurer. In doing so the Commission does not accept the argument that it is not supporting lower cost operations to the detriment

of the investor. The membership requirement that is being set out in the Policy and supported by this decision of the Saskatchewan Commission is also a requirement in the United States and in the United Kingdom. Given the global development of the securities business it is in the interest of all investors that the development of securities firms within the self-regulatory organizational structure be facilitated when it includes investor protection programs. It certainly would not be suitable nor in the public interest to have such securities growth taking place within an atmosphere of unequal opportunity to compete for the investor's business and without supervision. Any investor gain from lower costs would be at the expense of the stability and liquidity of the capital markets.

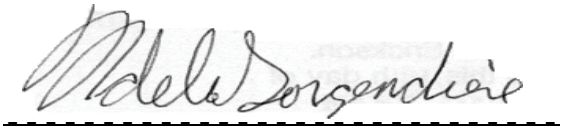
The Commission feels that it is not in the public interest to discourage the operation of smaller securities firms some of which have a role in specialty markets such as the development of regional based markets which pay some attention to new small business capital formation. Fostering of the development of such firms is in the public interest. Every investor gains through having an opportunity to have a real choice in the provision of services. Every entity wishing to raise money in the capital markets gains from having the largest number of possible investors exposed to their offerings. In other words, participating with some degree of protection in what is a volatile financial business is of benefit to everyone in the market and should be paid for by all participants. One cannot fault Scotia for attempting to take a step which takes advantage of all its resources in order to provide a lower cost service to its customers or profit its shareholders whichever the case may be, but for the larger interest shown above, this form of competitiveness cannot be accepted.

This Commission has no intention of changing its Policy in the present circumstances. It is the decision of the Commission that it is not in the public interest to register Scotia Securities Inc. as a securities dealer as long as it does not participate in the CIPF through membership in an approved self-regulatory organization. It is therefore, not necessary to determine the second question raised in the Notice of Hearing.

It is not the intention of the Commission to place undue restrictions on the operation of Scotia Securities Inc. in the event that it accepts the decision of the Commission and immediately commences negotiations with any of the self-regulatory organizations approved for membership by the Saskatchewan Securities Commission. If Scotia applies for registration with an indication to the Commission that it is so applying, it will be conditionally registered as a securities dealer subject to obtaining membership within a period of period of seven months from this decision. At the end of such period, if it has obtained membership, the registration condition will be removed and if not

the registration will be cancelled.

Dated at Regina in the Province of Saskatchewan this 3rd day of July, 1991.



Marcel de la Gorgendiere, Q.C.
Chairman