The Regulation of AIC Ltd. and FIC Ltd. by the B.C. Superintendent of Brokers

(The Principal Group Investigation)

Public Report No. 19

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Office of the Ombudsman

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Legislative Assembly
Province of British Columbia

OMBUDSMAN

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Overview

Approximately 17,000 British Columbians held investment contracts in AIC and FIC with a total value in principal and interest of more than $160 million on the day the licences of these companies to conduct business in B.C. were cancelled on July 2, 1987. Current estimates are that they will recover between 55% and 60% of this total value after liquidation and distribution of the AIC and FIC assets. In addition, the Alberta government has stated its intention to provide compensation sufficient to bring this recovery up to 75% for investment contract purchasers from all provinces, apparently on the condition that they agree to hold any other contribution received in trust for the benefit of purchasers from all provinces as well.

The B.C. investors, through individual complaints and through an association formed to represent their interests, have complained to the B.C. Ombudsman's office that their loss would not have occurred but for the failure of B.C. regulators to perform their statutory responsibilities. This is a report of the investigation conducted by this office and of the resulting conclusions and recommendations. Throughout this investigation, the Ombudsman's office has received the complete cooperation of B.C. government officials, past and present.

This public report includes a summary of the office's investigation into the B.C. regulatory history. This is necessary because there have been no public hearings in B.C. with respect to the collapse of the Principal Group of Companies. They have been held in Alberta through the court-ordered Code inquiry. It is also necessary because the practices and financial condition of AIC and FIC were matters of concern to B.C. regulators for almost

two decades, and an appreciation of the historical patterns during that period is crucial to an understanding of regulatory actions, omissions and decisions preceding the companies' collapse. The number of people affected, the amount of money at risk and the important public issues involved necessitate careful review.

It is important to note at the outset some readily apparent facts. First and most important, the incident is tragic. The investors are predominantly elderly and financially dependent for their retirement on the money at risk. They were not speculators but depositors in what they had legitimate reason to expect were financially responsible, competently regulated institutions. This profile was clearly identified in the Robinson report commissioned by Finance Minister Mel Couvelier shortly after the collapse.

The term 'administrative negligence' is used in this report to describe administrative acts, omissions or decisions of public officials in B.C. which failed to meet the standard of care that a reasonable person would recognize to be required of them. This is a common-sense test. The statutory responsibilities of the Superintendent of Brokers, as set out in the *Investment Contract Act*, provide a clear statement of that standard.

The major losses suffered by investors in investment contracts offered by AIC and FIC were foreseeable and would have been largely avoidable had the B.C. regulators acted reasonably to meet the standard set out in the statute. At a minimum, this standard required the regulators to ensure that all financial statements required of registrants under the Act were submitted in a timely manner and were examined to ensure that registrants at all times met the prescribed financial tests. The corporate practices that contributed eventually to the financial collapse of FIC and AIC in 1987 were known to B.C. regulators in the early 1970s, at which time appropriate steps were taken under the Act to protect investors. The statutory responsibilities that were recognized and discharged by the Superintendent of Brokers in the early 1970s were largely neglected from then until early in 1987.

It is reasonable to conclude that had the B.C. regulators continued to meet their statutory responsibilities, they would have become aware of the badly deteriorating financial situation of AIC and FIC in a timely way and would have either ordered effective remedial action or cancelled or suspended the companies' licences in time to prevent the major loss to the public which occurred.

The *Investment Contract Act* was unique legislation. It must be distinguished from securities legislation, which protects the individual investor by requiring mandatory disclosure of sufficient audited financial information to enable the investor to make a personal risk decision, and from banking or trust company legislation, which protects the individual depositor through mandatory deposit insurance and capital ratio requirements.

Because the *Investment Contract Act* did neither, the investment contract holder could only rely on the reasonable exercise of statutory responsibilities by B.C. regulators for the security of the investment. The degree of regulatory negligence in this case provided the opportunity for the *Investment Contract Act* to be used by AIC and FIC as a licence to deceive the public.

Many regulators, in their testimony to this office, referred to the fact that the powers given them by the Act were weak and its requirements were vague. However, actions taken both in the early 1970s and in 1987 indicate clearly that the Act had sufficient powers to regulate the companies effectively. Even if shortcomings existed and made the regulators' job more onerous, these in no way diminished their responsibility to administer the legislation to the best of their ability and to develop and apply clear policies and procedures to reduce the possibility of harm.

The compensation recommended at the conclusion of this report is not a charitable "bailout" for losses caused either by the investors' own fault or by third party actions outside of goverment control. Rather, it represents reasonable reimbursement for losses which were largely avoidable but for the clear and long-standing negligence of public officials in B.C. in the performance of their statutory responsibilities.

The recommendation is based on the significant degree of administrative negligence and its direct connection to the financial losses of the AIC and FIC investors. Although they must be presumed to have known the risks to investors, the officials responsible for regulating AIC and FIC under the *Investment Contract Act* failed variously to understand properly or in some cases even to read the statute; to take steps to ensure compliance with mandatory financial reporting requirements; to act effectively on public complaints related both to the suitability for licensing of AIC and FIC and to their deceptive trade practices; to act on significant indications of financial insolvency; to receive and review vital financial reports from Alberta regulators; and to act to halt known unlawful selling of investment contracts in B.C. by AIC and FIC while the companies' licences had lapsed. These negligent acts, omissions and decisions date back to at least 1979. Considered individually, some of them may not appear to be of great significance. However, their cumulative impact was substantial and over time adversely affected the interests of all B.C. investment contract holders as of July 2, 1987.

Several regulators suggested that a collapse would have been irresponsibly precipitated by stopping AIC and FIC from further selling or by notifying the public that they were not licensed to do business in B.C. This notion assumes that it is appropriate to fund current liabilities out of future investment contract sales. The suggestion that such a financing scheme might be required at any point should have been a clear indication to regulators that

the companies had serious financial problems and were a continuing danger to the public. To a large degree the reality of the threat of financial collapse is a measure of the extent to which the regulators had already been negligent in allowing the companies to operate in B.C. outside the statutory requirements.

The purpose of the *Investment Contract Act* was the protection of investment contract holders and potential purchasers, who would have been entitled reasonably to rely on the performance of regulatory responsibilities, having no independent access to essential financial information and no insurance or adequate capitalization protection against the financial failure of AIC and FIC. The major losses that occurred were foreseeable and preventable by B.C. regulators. The lack of effective regulatory action occurred not as a matter of considered public policy or through the bona fide exercise of discretion, but through negligent disregard for the responsibilities set out in the Act and for the interests of those specific individuals it was intended to protect.

This administrative negligence of B.C. regulators must be distinguished from the actions of their Alberta counterparts. It is evident from the Code Report that Alberta regulators were aware of the financial insolvency of AIC and FIC in 1984 but, under the direction of their Minister, deliberately failed to act on this information or to advise B.C. regulators of it. In B.C., the regulators were negligent in not becoming aware of this critical information in a timely way, either through their own direct review and analysis or, if they were to rely on Alberta as the primary regulatory jurisdiction, by requiring that Alberta supply them with this detailed information.

Although the head offices of AIC and FIC were in Alberta, the companies were required to be licensed under the B.C. *Investment Contract Act* in order to do business in this province. The companies' business in B.C. with which B.C. regulators had to be concerned was neither trivial nor incidental to their Alberta operations. Approximately $150 million was deposited with the chain of B.C. offices by more than 17,000 B.C. residents during the years immediately preceding the collapse. The statutory responsibilities of B.C. regulators to these B.C. investment contract holders are primary and unambiguous; no legal principle limits these responsibilities through an administrative deference to the judgements and actions of Alberta regulators. During the early 1970s there was regular and effective communication between B.C. and Alberta regulators. This deteriorated in the 1980s to the point that, in the years immediately preceding 1987, neither bothered to advise the other adequately of its concerns, knowledge or actions, or to demand from the other the cooperation necessary to meet the regulators' respective statutory responsibilities.

B.C. regulators have stated that in the years preceding the Principal collapse they often relied on Alberta, as the province of primary jurisdiction, to conduct a close monitoring of the practices and financial condition of AIC and FIC and to forward information to B.C. For the most part that information was not provided and B.C. did little to pursue it. The theory of

primary jurisdiction is an informal and unlegislated arrangement between provinces. Its use did not reduce the responsibility of the B.C. regulators to perform fully their statutory responsibilities to B.C. investors and to ensure they were in possession of all information needed to fulfil those responsibilities.

If the B.C. government thinks that Alberta has not respected the terms of this informal arrangement (as it has been suggested in the Code Report that it did not), it should negotiate with the Alberta government an agreement to share more fully the responsibility for the compensation of B.C. investors. Given the importance of the notion of primary jurisdiction to all provinces, and the current negotiations to formalize it for all financial regulation across the country, B.C. should be in a strong position to do so. However, B.C. investors are not a party to their government's arrangements, and it would be unjust for the B.C. government to leave them to their own resources to pursue the Alberta government for compensation.

Many of the regulators who gave evidence during this investigation referred to inadequate resources in the Superintendent of Brokers' office. Such problems are not unique in government. It is not for the Ombudsman's office to comment on policy decisions regarding the allocation of scarce resources. However, where government decides to legislate specific regulatory responsibilities, it must ensure that adequate resources are provided to its officials to fulfil them.

It is important to note that this office has found no indication of attempts by anyone to improperly influence politicians or public servants in B.C. with regard to the regulation of AIC and FIC. There is also no indication that any improper political influence or direction was brought to bear on B.C. regulators in relation to these companies. There is also no indication that any public servant acted with improper motive.

This report includes a summary of the factual history of the involvement of B.C. government officials with AIC and FIC from 1970 to 1987. It identifies the many negligent breaches of statutory responsibility during this period and identifies a direct cause and effect relationship between this administrative negligence and the major financial losses suffered by the investors in these companies.

A finding of administrative negligence and a recommendation for compensation to remedy the harm caused by it under section 22 of the *Ombudsman Act* is not necessarily based on the same findings as a court would require to establish legal liability. The Ombudsman's authority to recommend remedial action derives from the premise that a fair remedy with respect to administrative wrongdoing is not always available at law. This is a premise that is fundamental to the creation of the institution of the Ombudsman as an entity separate from the formal justice system.

To a large extent, the office of the Ombudsman was established by the Legislature in recognition of the inadequacy of the courts to deal with many injustices arising from the nature of modern bureaucracy. To quote Chief Justice Dickson from a unanimous decision of the Supreme Court of Canada:

> The limitations of courts are also well known. Litigation can be costly and slow. Only the most serious cases of administrative abuse are therefore likely to find their way into the courts. More importantly, there is simply no remedy at law available in a great many cases
>
> Read as a whole, the Ombudsman Act of British Columbia provides an efficient procedure through which complaints may be investigated, bureaucratic errors and abuses brought to light and corrective action initiated. It represents the paradigm of remedial legislation. It should therefore receive a broad, purposive interpretation consistent with the unique role the Ombudsman is intended to fulfil.[1]

Section 22 of the *Ombudsman Act* authorizes the Ombudsman to conclude that public officials, in the administration of their duties, have acted negligently and, where this has occurred, to recommend to government the means by which the harm caused by such failure should be remedied. This authority is independent of the existence of a private law remedy through the courts.

The strict legal principles by which the courts determine the liability of public officials for the consequences of their negligence are complex and uncertain. While a strong legal argument can be made out that government, because of the administrative negligence of its officials, is legally liable to the investors for their losses in this case, such liability is not certain and would only be settled by a decision of the Supreme Court of Canada, which would take many years at vast public and private expense. In addition, whatever the ultimate court decision might be, it would not lessen for the investors the years of financial uncertainty already suffered or the degree of administrative negligence identified in this report.

In many situations, the law does not apply to the actions of public administrators in the same manner as it applies to those of private citizens. The Law Reform Commission of Canada has recently commented on this dilemma:

> Concepts and principles which are appropriate to private law are often ill-suited to deal with problems arising in the public law context. Tort liability of the Crown, for instance, is addressed in the same terms as are used to determine liability between private parties. The use of private law offers many opportunities for the State to escape liability which we might, as a matter of public policy, want it to bear.
>
> As well, given the fundamental economic inequality between the parties and the extraordinary procedural privileges enjoyed by the Administration, the procedure which governs curial [court] proceedings in contentious matters is manifestly ill-adapted to the special nature of litigation between the individual and the Administration
>
> One non-curial external control could be provided by ombudsmen... This institution is non-adversarial in nature and exemplifies the diverse avenues of redress for individuals, which, although non-judicial, can and do enjoy a high degree of independence.[2]

Like the Supreme Court of Canada, the Law Reform Commission points out the effectiveness of an Ombudsman office in identifying error and resulting harm and in recommending a remedy in situations where there may simply never be a fair judicial resolution of the harm caused by bureaucratic error.

The fact that the application of strict legal principles and processes may not provide a remedy in all cases does not mean that government can ignore its responsibility to remedy the consequences of the negligence of its own officials. It has a duty to treat people fairly, not simply to meet technical legal standards, and when individuals have been harmed through the clear failure of public officials to act reasonably in their administrative duties, government should act quickly to remedy that harm.

While the administrative negligence of B.C. regulators was a major contributing cause of the B.C. investment contract holders' losses, it was not the only cause. Alberta government officials deliberately declined to act on clear evidence of the insolvency of AIC and FIC in 1984, and failed to advise B.C. regulators of this evidence. The Alberta government has accepted a measure of responsibility to B.C. investors by extending to them its compensation offer of ensuring 75% recovery. As identified in the Code Report, corporate officials of AIC and FIC did not act in the best interests of investment contract holders, failed to deal with the impact of the real estate collapse, and were a direct cause of the losses. Finally, the investment contracts could not have been totally secure investments, even if the companies had been perfectly regulated, because government regulators could not have been reasonably expected to exercise total and immediate control over the companies. The quarterly review of financial statements, together with regulatory due process, created an unavoidable time lag during which some losses could occur before a responsible decision to cancel licences could be made.

However, given the extensive administrative negligence of public officials in B.C. identified in this report, it would be unconscionable for the B.C. government to attempt to evade its responsibilities by putting those affected to years of expensive and debilitating litigation against itself. The reality for many of the elderly investors is that they would not survive the process.

In all of these circumstances, it is recommended that the B.C. government meet its responsibility to B.C. investment contract holders by supplementing their recovery from asset liquidation and distribution such as to achieve an overall 90% recovery of losses of principal and interest to July 2, 1987. Given the conditions which Alberta has imposed on the acceptance of its offer to investors, the B.C. government should negotiate aggressively to achieve a significant contribution from Alberta to compensate for the consequences of its deliberate failure to keep B.C. officials properly advised. Further, it is recommended that the B.C. government assist the investors financially to pursue whatever legal recourse might be available against company officials or other parties in order that they might eventually recover 100% of their losses, as they deserve to do.

This recommended compensation and assistance should not be considered to be an expensive precedent, because the situation is unique. Since the collapse of AIC and FIC, the *Investment Contract Act* has been repealed in B.C., and the many bureaucratic failures identified in this report are being or have already been addressed by the Superintendent of Brokers' office, the Ministry of Finance and Corporate Relations and the Securities Commission. However, the case should serve as a clear reminder to government that if it is to legislate to itself statutory responsibility then it must protect the public from the harm caused by the administrative negligence of its officials in failing to fulfil that responsibility.

Stephen Owen
Ombudsman

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Acknowledgments

The extensive investigation which formed the basis for this report has put an extraordinary strain on the Ombudsman office over the past 18 months. I would like to recognize the outstanding service during this period of Elizabeth A. Arnold and Michael A. Ross in leading the investigation for this office. As well, I would like to thank the rest of the Ombudsman staff for cheerfully bearing the extra burden caused by this undertaking.

Although this report is not intended to be a technical accounting analysis, I am grateful to the Auditor General's office and the Institute of Chartered Accountants for their valuable advice and time in reviewing this document for technical accuracy.

Publishing expenses were minimized through the assistance of the *Hansard* office of the Legislature, which typeset this report.

Finally, I would like to acknowledge the full cooperation and very considerable effort of officials of the Ministry of Finance and Corporate Relations, the Superintendent of Brokers' office, and the Ministry of the Attorney General in responding to all requests and inquiries arising in this investigation, and demonstrating complete dedication to ensuring a fair and accurate account.

S.O.

Table of Abbreviations

AHL	Athabasca Holdings Ltd.
AIC	Associated Investors of Canada Ltd.
ASC	Alberta Securities Commission
BCSC	British Columbia Securities Commission
CDIC	Canada Deposit Insurance Corporation
CICA	Canadian Institute of Chartered Accountants
FIC	First Investors Corporation Ltd.
PCL	Principal Consultants Ltd.
PGL	Principal Group Limited
PS&T	Principal Savings & Trust Company Limited

Chapter I

Introduction

Complaints to the Ombudsman

On September 3, 1987, a North Vancouver couple complained to the Office of the Ombudsman about the manner in which the Office of the Superintendent of Brokers had regulated the licensing of First Investors Corporation Ltd. (hereafter FIC), a company engaged in the sale of investment contracts. They had purchased an investment contract with FIC on May 16, 1986, in the amount of $17,000. The husband had later obtained information indicating that FIC had not been licensed to carry on business in British Columbia between April 1 and August 28, 1986. He was of the opinion that, in allowing FIC to carry on business without a licence, the Superintendent of Brokers had been derelict in his duty to enforce the provisions of the British Columbia *Investment Contract Act*.[1] The couple's complaint was the first to our office from more than 120 individuals and from the 5,500-person membership of Principal Investors Protection Association concerning the regulation of FIC and Associated Investors of Canada Ltd. (hereafter AIC) in British Columbia. Both companies were wholly owned by Principal Group Ltd. (hereafter PGL).

Inquiries Following the Collapse of the Principal Group

On Tuesday, June 30, 1987, FIC and AIC both made an application to the Alberta Court of Queen's Bench pursuant to the federal *Companies Creditors Arrangement Act*. The court granted the application of each company and appointed chartered accountants Coopers & Lybrand as managers of the assets and liabilities of the companies. As the result of the court's decision, the Alberta Treasury Department on that same day cancelled the licences of AIC and FIC to operate in Alberta. Two days later, following the Canada

Day holiday, the Superintendent of Brokers of British Columbia cancelled the licences of AIC and FIC to operate in B.C.

The collapse of the investment contract companies had an immediate effect on the other companies in the group. On August 10, 1987, PGL made a voluntary assignment in bankruptcy pursuant to the *Bankruptcy Act*. On August 17, 1987, the Alberta Court of Queen's Bench, pursuant to a request by Canada Deposit Insurance Corporation (hereafter CDIC), granted an order winding up Principal Savings and Trust Co. (hereafter PS&T).

Immediately upon the collapse of AIC and FIC, investors' complaints began flooding into the regulatory bodies of each province. A common thread ran through these complaints: most of the people had been told their investments were guaranteed, and many believed their investments were not with AIC or FIC but rather with PS&T, another company in the Principal Group that was 95 percent owned by PGL and on whose premises AIC and FIC had sold investment contracts. PS&T products were CDIC-insured.

As a result of both the volume and nature of the complaints, both provincial governments set up inquiries. The British Columbia Minister of Finance and Corporate Relations, Hon. Mel Couvelier, appointed Lyman Robinson, Q.C., former Dean of Law at the University of Victoria, on July 15, 1987, to investigate misleading sales practices by the companies pursuant to the *Trade Practice Act*. By court order of August 13, 1987, the Alberta Court of Queen's Bench appointed William Code, Q.C., of Calgary as an inspector. His terms of reference contained the following instructions:

> The inspector may conduct such hearings as he requires from time to time and shall have the power to summon and compel attendance of witnesses and, without restricting the generality of the foregoing, shall have the power to summon Ministers of the Crown in right of Crown of the Province of Alberta and their deputies and employees of the Province of Alberta duces tecum or otherwise require production of documents, administer oaths and may seek advice and directions with respect to such proceeding from time to time as required.

The Code inquiry began immediately after that order and held hearings for well over a year with final arguments being submitted in March 1989. Mr. Code had been given two months after the submission of final argument to provide a written report to the Alberta Court of Queen's Bench. On May 4, 1989, Mr. Code received a 60-day extension for submission of the report, which was submitted to the court on July 18, 1989. Although the Code inquiry was concerned primarily with the reason for the financial collapse of the Principal companies, it heard testimony from government regulators from both Alberta and British Columbia.

In the fall of 1987 the Alberta Ombudsman initiated his own inquiry into the conduct of the Alberta regulators with regard to the discharge of their responsibilities pursuant to the *Investment Contracts Act* of Alberta. His report was released on August 28, 1989.

Lyman Robinson's report to Mr. Couvelier, submitted October 14, 1987, noted that its terms of reference provided

> that an inquiry be undertaken to determine whether First Investors Corporation Ltd., Associated Investors of Canada Ltd., Principal Savings & Trust Company, Principal Consultants Ltd., and Principal Group Ltd., or any of them engaged in misleading or deceptive acts or practices in respect of consumer transactions pertaining to investments offered by these companies.[2]

In his report, Mr. Robinson provided the following overview of the sales practices engaged in by the companies:

> Many of the people whose funds are at risk, as a consequence of the failure of First Investors Corporation Ltd., Associated Investors of Canada Ltd., and Principal Group Ltd., are persons who have reached or are approaching normal retirement age. Thirty-four percent of the investors who returned questionnaires to the Commission were over the age of 65 years and this percentage increases to 51% if persons over 60 years of age are included in the analysis. Their funds, which are at risk, are for the most part funds which they had saved for their retirement years. Many of these people had little if any experience with respect to investing money. Indeed, they did not regard themselves as investors but rather as "savers". When they went to "Principal" they were looking for a financial institution where their retirement savings would be kept safely and bear interest at a competitive rate. Some of them transferred their funds to "Principal" from a chartered bank or other financial institution where the funds were covered by CDIC insurance. There were often several reasons why they transferred their funds to Principal. In some cases, there is no doubt they were involved in "interest rate shopping", but this was usually done on the assumption that they were comparing interest rates among financial institutions which offered the same form of security. In some cases the interest rate offered by "Principal" was either the same as the rate being offered by some of the chartered banks, or the rate offered by "Principal" was only one-quarter to one-half of one percent higher than the rate offered by a chartered bank. The assumption that "Principal" offered the same financial security as other financial institutions was often the product of representations which were made by the Principal consultants or sales personnel... Most of these people did not think they were speculating with their savings by investing in high risk investments or second mortgages with interest rates substantially higher than rates on bank term deposits.[3]

Section 13 of the Robinson report is titled "Business Practices which tended to Deceive Investors". Mr. Robinson identified three such practices:

> 1. the practice of not making a clear public demarcation between Principal Savings and Trust Company and Principal Consultants Ltd.;
> 2. displaying signs referring to maximum CDIC coverage as being $20,000;
> 3. roll-over of investments from Principal Savings and Trust Company to FIC/AIC.[4]

The Robinson inquiry was not an inquiry into the regulation of investment contract companies by the Superintendent of Brokers, notwithstanding some passing remarks on the topic.

The Ombudsman's Jurisdiction

The Ombudsman's authority to investigate the regulation of AIC and FIC by the Superintendent of Brokers in British Columbia proceeds from section 10 of the *Ombudsman Act*, subsection (1) of which reads as follows:

> 10. (1) The Ombudsman, with respect to a matter of administration, on a complaint or on his own initiative, may investigate
> (a) a decision or recommendation made;
> (b) an act done or omitted; or
> (c) a procedure used
> by an authority that aggrieves or may aggrieve a person.

Section 16 of the Act provides for procedures to be followed by the Ombudsman if initial investigation suggests there is sufficient merit to a complaint to warrant the making of a report or recommendation:

> 16. Where it appears to the Ombudsman that there may be sufficient grounds for making a report or recommendation under this Act that may adversely affect an authority or person, the Ombudsman shall inform the authority or person of the grounds and shall give the authority or person the opportunity to make representations, either orally or in writing at the discretion of the Ombudsman, before he decides the matter.

This section ensures that those authorities or individuals reported upon have an opportunity prior to the release of a report by our office to comment or provide us with further evidence.

Sections 22 and 30 of the *Ombudsman Act* outline the procedures that may be followed once an investigation has been completed:

> 22. (l) Where, after completing an investigation, the Ombudsman believes that
> (a) a decision, recommendation, act or omission that was the subject matter of the investigation was
> (i) contrary to law;
> (ii) unjust, oppressive or improperly discriminatory;
> (iii) made, done or omitted pursuant to a statutory provision or other rule of law or practice that is unjust, oppressive or improperly discriminatory;
> (iv) based in whole or in part on a mistake of law or fact or on irrelevant grounds or consideration;
> (v) related to the application of arbitrary, unreasonable or unfair procedures; or
> (vi) otherwise wrong;
> (b) in doing or omitting an act or in making or acting on a decision or recommendation, an authority
> (i) did so for an improper purpose;
> (ii) failed to give adequate and appropriate reasons in relation to the nature of the matter; or
> (iii) was negligent or acted improperly; or
> (c) there was unreasonable delay in dealing with the subject matter of the investigation,

the Ombudsman shall report his opinion and the reasons for it to the authority and may make the recommendation he considers appropriate.

(2) Without restricting subsection (1), the Ombudsman may recommend that

(a) a matter be referred to the appropriate authority for further consideration;
(b) an act be remedied;
(c) an omission or delay be rectified;
(d) a decision or recommendation be cancelled or varied;
(e) reasons be given;
(f) a practice, procedure or course of conduct be altered;
(g) an enactment or other rule of law be reconsidered; or
(h) any other steps be taken.

30. (2) The Ombudsman, where he considers it to be in the public interest or in the interest of a person or authority, may make a special report to the Legislative Assembly or comment publicly respecting a matter relating generally to the exercise of his duties under this Act or to a particular case investigated by him.

Because of the large numbers of British Columbians severely affected by the subject matter of this investigation, and the important issues involved, the Ombudsman has concluded that it is in the public interest to make this report directly available to the public pursuant to s.30(2).

Focus of the Investigation

The *Investment Contract Act*, prior to its repeal on May 10, 1988, imposed upon the Superintendent of Brokers certain responsibilities with regard to the regulation of investment contract companies in British Columbia. Complaints submitted to this office alleged that the Superintendent of Brokers did not duly discharge these responsibilities. As a result of these complaints and other information that came to light, the Ombudsman decided to examine the role played by the Office of the Superintendent of Brokers in British Columbia with respect to the regulation of AIC and FIC.

Unlike the Code inquiry, this investigation has not focused on an attempt to explain why the Principal Group of Companies collapsed. Nor, as was the case with the Robinson inquiry, is the focus to determine whether or not misleading sales tactics took place in B.C.—the Robinson inquiry determined that they did. Rather, in accordance with the jurisdiction provided by the *Ombudsman Act*, this investigation has sought to determine whether the Office of the Superintendent of Brokers discharged the responsibilities imposed upon it by the *Investment Contract Act* of British Columbia with respect to its regulation of AIC and FIC.

Chronology of the Investigation

In early January of 1988 the Ombudsman met with the Assistant Deputy Minister, Corporate Relations, of the Ministry of Finance and Corporate Relations and with the incumbent Superintendent of Brokers, Neil de Gel-

der, in order to formalize arrangements for the investigation of the Superintendent of Brokers' office.

This investigation may most easily be described as unfolding in three phases. The first phase lasted from January to September 1988 and was concerned with the collection of material relevant to the investigation. The second lasted from September to December 1988, during which time approximately three dozen government and former government employees were examined under oath. The third began in January 1989 and involved the organization of materials and evidence and the writing of this report. These divisions are somewhat oversimplified, given the fact that new material continued to reach us throughout the duration of the investigation and we continued to examine or re-examine witnesses into the month of June 1989.

On January 13, 1988, a letter was delivered by hand to the Superintendent of Brokers enclosing a preliminary questionnaire from Ombudsman Stephen Owen to Neil de Gelder comprising 88 questions. From mid-January to the third week of February our office conducted a document search throughout the Office of the Superintendent of Brokers. In light of new information gathered, a revised questionnaire containing 95 questions was sent on April 20. We asked for a response to be submitted by June 1, 1988.

On May 17, 1988, the Superintendent of Brokers wrote to advise us that he would be unable to meet the June 1 deadline but that an individual with a background in both law and accounting had been hired strictly to work on this project; he would commence work on May 24, 1988.

We received the response to our questionnaire on September 13, 1988. By this point we had amassed approximately 5,000 pages of evidentiary material.

The second phase of the investigation began on September 19, when we began hearings under oath of government and former government employees. Initial examinations were concluded on December 22, 1988. During that period we examined 34 individuals, some of them two or three times. At each hearing, an official court reporter was present. All but two of the witnesses also had a lawyer from the provincial Attorney General's office present.

We examined every Superintendent and Acting Superintendent of Brokers from 1962 to 1987. We also interviewed all Deputy Superintendents of Brokers and Acting Deputy Superintendents of Brokers from 1979 to 1987. We examined all Directors and Acting Directors of Registration as well as Deputy Directors and Acting Deputy Directors of Registration from 1972 to 1987. We also examined all clerks involved with the registration of AIC or FIC from 1979 to 1987.

To further the investigation we also examined all government accountants whom we knew to be involved with AIC and FIC from 1970 to 1987. We examined the Superintendent and Deputy Superintendent of Credit Unions, Co-operatives and Trust Companies who were concerned with the regulation of PS&T during the late 1970s to the mid-1980s. We examined

Directors of Policy and Planning who had some dealings with the *Investment Contract Act* in the mid-1980s, and we examined the former Assistant Deputy Minister and Deputy Minister of Consumer and Corporate Affairs who held those offices from 1982 to 1986.

To ensure that we understood what investigations had been done with regard to any of the Principal Group of Companies we examined the Ministry's Director of Investigations, his predecessor, and investigators and inspectors.

We believe that we have had access to all the information held by the government of British Columbia that has any relevance to this investigation and to all those people who were even peripherally concerned with the regulation of AIC and FIC in British Columbia.

Beginning in January 1989 we began to sift through the material, categorize it and plan our report. By this time the number of pages of documentation submitted to us had grown to approximately 20,000. We have received documentation not only from the government of British Columbia but also from the government of Alberta, the Code inquiry, the trustee in bankruptcy for PGL and the court-appointed manager for both AIC and FIC. Material continued to arrive well into June 1989.

While information obtained during an Ombudsman investigation is, as a general rule, held confidentially, section 9(6)(c) of the *Ombudsman Act* authorizes the Ombudsman to disclose information that is necessary to establish grounds for his conclusions and recommendations made in a report under the Act. It is for this reason, and in the public interest pursuant to section 30(2) of the Act, that a summary of the information relating to administrative negligence of public officials, including that which was given in direct testimony, is set out in this report. Those providing testimony to this office were advised of this possibility at the outset. They were also given the opportunity to be accompanied by counsel when interviewed, and in this regard almost all current and former B.C. government officials took advantage of the opportunity to be represented by a lawyer from the Attorney General's Ministry. All material quoted in this report is drawn from testimony and representations provided to this office, except where otherwise noted.

A 900-page draft investigative report was submitted to the government on July 24, 1989. Pursuant to section 16 of the *Ombudsman Act*, all authorities or other persons that could be adversely affected by this report have been given the opportunity to make representations. All such representations have been given full consideration by the Ombudsman before the matters dealt with in this public report have been finally decided by him.

Outline of the Report

As will be evident from the report, the files retained by the Superintendent of Brokers in British Columbia were inadequate to allow us to piece together what happened. Documents which continued to come to light in the course of the investigation and which dated from the early 1970s indi-

cated that some of the problems existing when the companies collapsed in 1987 had been evident in British Columbia in the early 1970s. Accordingly, unlike the Code inquiry, which emphasized the period after 1980, we begin our analysis by going back to April 3, 1970—the date at which the Superintendent of Brokers assumed responsibility from the Superintendent of Insurance for regulating investment contract companies in British Columbia.

Of particular note is the fact that there were no records for AIC on file with the Office of the Superintendent of Brokers for the years prior to 1983. This absence of documentation, combined with sometimes uncertain recollections by witnesses, rendered the task of evaluating the performance of the Superintendent of Brokers extremely difficult. On April 28, 1989, we were able to obtain some AIC company records from Coopers & Lybrand, the trustee in bankruptcy for AIC and FIC. These enabled us to determine that AIC became unlicensed on April 1, 1973 and was relicensed on January 26, 1978.

On May 10, 1989, we received from the government of Alberta a great number of documents that were essentially correspondence between Alberta and B.C. regarding AIC and FIC. Alberta had retained these documents and correspondence; British Columbia had not. These documents provided, in essence, a portrait of those British Columbia regulators who had been heavily involved in monitoring the affairs of AIC and FIC in the early 1970s. They also indicated that a great deal of co-operation had taken place during that period between Alberta and British Columbia regulators with regard to AIC and FIC. Evidence entered at the Code inquiry reveals that that co-operation was not present in the mid-1980s.

The continuing arrival of documents led us to examine and re-examine some witnesses in May and June of 1989 and necessarily delayed the writing of this report.

We have received full co-operation from the government of British Columbia and in particular from the Office of the Superintendent of Brokers and Attorney General's Ministry counsel. We take this opportunity to note their assistance and courtesy.

This report comprises twelve chapters and a series of appendices. It is lengthy, even with only a summary of the evidentiary history, not only because of the time period involved but also because of the complexity of the issues. One cannot fairly evaluate the performance of an office such as that of the Superintendent of Brokers in relation to its regulation of two investment contract companies unless one understands the broader picture.

Not only was the issue of regulation of businesses falling under the *Investment Contract Act* complex, but the number of Principal companies was large and their interrelationships labyrinthine. In attempting to evaluate the performance of the Office of the Superintendent of Brokers, we have borne in mind the unusual circumstances faced by those responsible for regulating the Principal companies. We have therefore attempted to evaluate the performance of the Superintendent of Brokers in context. The *Ombudsman Act* requires fair treatment for all persons, including the Superintendent of Brokers and his officials.

The report begins, in Chapter II, by presenting a brief overview of the Principal Group of Companies. Specifically, we examine those companies that were registered in British Columbia and the interrelationship among them. We also describe the nature of investment contracts and how they were marketed in British Columbia by companies belonging to the Principal Group.

In Chapter III we provide an overview of the Office of the Superintendent of Brokers. We begin by tracing the growth of the office from 1970, when the Superintendent of Brokers was given the duty of administering the *Investment Contract Act*, to 1987, when the Principal Group collapsed. This part of the report includes a brief description of the office's major divisions: the Registration and Records Department, the Financial Filings Department and the Investigations Department.

Chapter IV reviews the requirements of the *Investment Contract Act* and the responsibilities imposed by it upon the Superintendent of Brokers.

Chapter V reviews the regulation of PS&T by the appropriate British Columbia regulators. While our investigation is not directed at the office of what was then the Superintendent of Credit Unions, Cooperatives, and Trust Companies, that office played an indirect role in the regulation of AIC and FIC. This occurred because investment contracts were usually sold on the same premises occupied by PS&T.

Chapters VI through X provide a summary of the evidentiary history of the regulation of AIC and FIC in British Columbia essentially from April 3, 1970 to July 2, 1987.

Chapter XI presents a financial commentary on the regulation of AIC and FIC.

Chapter XII contains our findings, based upon the analysis of the regulatory response to AIC and FIC by the Superintendent of Brokers in British Columbia, and our recommendation.

Notes to each chapter are to be found at the end of the report, under "Endnotes."

The series of appendices that follow the main body of the report have been inserted to provide relevant points of reference that may be helpful to readers of the report and to illustrate at a glance some of the more pertinent aspects of our investigation.

Chapter II

The Principal Group of Companies

An Overview of the Principal Group

"The Principal Group" is a term commonly used to refer either to Principal Group Ltd. or to the Principal Group of Companies. The latter was a group of almost 40 companies operating in Canada and the United States; the former was one of those companies. In this report, the term refers to the group of companies.

AIC and FIC were each wholly owned by PGL, which was in turn wholly owned by Collective Securities Inc. The latter company was owned 10.5 percent by Kenneth Marlin's MMI Holding Co. and 80.5 percent by Donald M. Cormie, who thereby had effective control of both AIC and FIC. The remaining 9 percent was equally divided between Mr. Cormie's two sons, James and John.

Principal Group Companies Registered in B.C.

The members of the Principal Group of Companies registered in B.C. were closely interrelated. PGL, which was originally registered in B.C. on January 3, 1967, sold promissory notes pursuant to an exemption under the *Securities Act*. AIC was incorporated in Alberta on May 3, 1948, and registered in B.C. on June 19, 1950. After the enactment of the *Investment Contract Act* in 1962, AIC sought and obtained registration to sell investment contracts in B.C. FIC was incorporated on February 3, 1954, and registered in B.C. on October 14, 1954. Corporate registration files in the Office of the Superintendent of Brokers show no salespersons ever having been registered under the corporate name AIC and salespersons having been regis-

tered under the corporate name FIC only for the registration years 1963-64, 1964-65 and 1965-66.

Another Principal Group company, PS&T, 95 percent owned by PGL, was registered in B.C. on May 24, 1966. It maintained offices throughout the province as a trust company, and its products, like those of its Alberta counterpart, were insured to a maximum of $20,000 until 1983, when that protection was increased to $60,000. AIC and FIC investment contracts, frequently sold by Principal Consultants Ltd. (hereafter PCL) (on behalf of AIC and FIC) on the premises of PS&T, were not eligible for CDIC insurance coverage, although some investors were told by salespersons that their deposits were CDIC-insured. When PGL collapsed in the summer of 1987, after the licences of AIC and FIC were cancelled in Alberta and B.C., CDIC applied for a winding-up order for PS&T. This was granted by the Alberta Court of Queen's Bench on August 17, 1987.

PCL, also owned by PGL, was incorporated on December 4, 1970, and registered in B.C. on July 15, 1971. Its agents marketed the various financial products, including investment contracts, of the Principal Group of Companies and received higher commissions for selling the products of AIC and FIC, which were not CDIC-insured, than for selling those of PS&T.

The four companies described above—AIC, FIC, PS&T and PCL, all wholly or partially owned by PGL—were closely interwoven in their business operations. By the late 1970s, AIC and FIC—the companies in the group that were registered to sell investment contracts in B.C.—did not have their own sales staff and relied on PCL employees to sell their investment contracts. Similarly, for the most part, PS&T relied upon the employees of PCL to sell its products. PCL, while selling the products of the other three companies, did not own its own premises but operated out of PS&T branches or adjacent premises.

As Lyman Robinson noted in his report on Principal Group business practices, there was neither a clear demarcation between the premises used by the different companies nor public identification as to whether staff worked for PCL or PS&T. This fact, Robinson concluded, caused investors to be misled or deceived about the identities of the companies with which they were dealing.

Persons selling investment contracts issued by AIC and FIC were registered under the *Securities Act* rather than under the *Investment Contract Act* (as permitted under section 4(2)(d) of the *Investment Contract Act*), and were registered as employees of PCL rather than of AIC or FIC.

Types of Investment Contracts

Section 1 of the British Columbia *Investment Contract Act* defined "investment contract" as

> a contract, agreement, certificate, instrument or writing containing
>
> (a) an undertaking by an issuer to pay the holder, his assignee, personal representative or other person a stated or determinable ma-

> turity value in cash or its equivalent on a fixed or determinable date; and
>
> (b) optional settlement, cash surrender or loan values, before or after maturity, for which the consideration is a single sum, or payments made or to be made to the issuer periodically, according to a plan fixed by the contract, whether or not the holder may be entitled to share in the issuer's profits or earnings, or to receive additional credits or sums from the issuer.

Only a small number of companies—two of them being AIC and FIC—were licensed to sell investment contracts in B.C. Initially, AIC and FIC referred to their contracts as "accumulation contracts", under which purchasers would pay a specified amount in periodic sums. In the mid 1970s, however, they began switching to "single payment contracts". By 1980, according to the estimate of an investors' lawyer appearing before the Code inquiry, single payment contracts represented more than 90 percent of the liabilities of AIC and FIC to investment contract holders.

In either form of contract—periodic or single payment—a purchaser received from AIC and FIC a certificate that stated that the company would pay to the purchaser, in addition to the amount advanced to the company by the purchaser, interest at a stated rate. In later years, the companies agreed to pay "additional credits". For example, newspaper advertisements frequently described the contracts as paying 11 percent, when only 4 percent was guaranteed in the contract, the remainder being payable at the option of company directors.

Chapter III

The Office of the Superintendent of Brokers

The Office of the Superintendent of Brokers, Insurance and Real Estate had concerns about the practices of AIC and FIC from the time it began to regulate investment contract companies in 1970. Later chapters in this report detail the regulation of those companies in the 1970s and 1980s. An understanding of the role and structure of the office is useful in order to appreciate the circumstances that existed when the Principal Group of Companies collapsed in 1987. Accordingly, this chapter describes the evolution of the office during that lengthy period.

The office was set up to ensure the existence of an orderly financial marketplace. To that end, the various statutes that governed different types of enterprises gave the Superintendent of Brokers the responsibility to determine whether companies met statutory requirements for registration in B.C. and to monitor their practices and take corrective action when necessary in the public interest. Companies were required to file a variety of documents, most notably their financial statements, with the office for scrutiny on a regular basis, and to provide such other information as the statutes authorized the Superintendent to obtain.

Noteworthy Events, 1970-87

Acquisition of Responsibility for Investment Contracts

On April 3, 1970, responsibility for the regulation of investment contract companies was transferred to the Superintendent of Brokers from the Superintendent of Insurance, who had regulated them since the enactment of the *Investment Contract Act* in 1962. At the time of the transfer, the Office of the Superintendent of Brokers comprised a Deputy Superintendent, three

or four accountants and clerical staff under the direction of Superintendent W.S. (Bill) Irwin, who had held that post since 1962. Mr. Irwin told us the transfer caused him concern. He believed the regulation of investment contract companies, given the nature of their business, fell more properly under the supervision of the Superintendent of Insurance. In addition, he said, his office was ill equipped, because of staff shortages, to handle the tasks for which it was already responsible.

Under the initial procedure devised by the office for the regulation of investment contract companies, a registration clerk, on receipt of a company's quarterly or annual financial statements, would forward them to whichever accountant was "looking after" the company. In 1972, the post of Director of Registration and Records was created and the new Director proceeded to set up the Registration and Records Department, described in the second part of this chapter. An investigative office in Vancouver looked into complaints received and irregularities detected in relation to companies regulated by the Superintendent of Brokers. By the latter part of the decade the office structure had evolved into three distinct parts: the Registration Department, which received company documents and processed registration applications; the Filings Department, to which documents were forwarded whenever a financial analysis was considered necessary; and the Investigations Department, whose purpose was to follow up on concerns raised by analysts in the Filings Department and to investigate complaints.

Expansion of Jurisdiction

In the latter part of 1976, the Office of the Superintendent of Brokers was transferred from the Ministry of the Attorney-General to the Ministry of Consumer and Corporate Affairs. A little over a year later, in January 1978, the responsibilities for the Real Estate and Insurance Branch of the Department of Consumer and Corporate Affairs were added to the Office of the Superintendent of Brokers. With the responsibility for about 12,000 real estate licences and 8,000 to 10,000 insurance licences added on to the existing responsibility for regulating 1,500 to 2,000 securities registrants, the office workload increased dramatically. Mr. Irwin told us that he requested, without success, additional staff to handle the burden imposed by his new duties. Shortly after the office's move from Victoria to Vancouver in September 1978, the total staff was 35, largely untrained replacements for Victoria staff who had been reluctant to move.

The added responsibility for issuing insurance and real estate licences and the growing complexity of the financial markets made it apparent that a more sophisticated method of processing registration applications was required. In the summer of 1979 a draft "Project Definition Report" was prepared for the Superintendent of Brokers, Real Estate and Insurance. It analyzed the capacity of the office to manage its responsibilities and proposed alterations in its structure and procedures. It concluded that the efficiency of the office was hampered by (1) a staff shortage combined with the presence of untrained new staff; (2) inconsistent and, in some cases, non-existent policies and procedures; (3) an inefficient filing system which

resulted in a lack of security of files and a lack of ready access to information on companies; and (4) inadequate checks on fulfilment of statutory requirements by companies seeking registration. It called for a streamlining and standardization of policies and procedures used to administer the various Acts for which the Superintendent was responsible; improved cross-referencing of relationships between companies and individuals; implementation of a bring-forward system for correspondence and actions required; and improved audit controls prior to the issuance of licences. An effort to implement the recommendations of the report led to the introduction of a computerized registration and filing system by the early 1980s.

With Mr. Irwin's retirement in January 1980, Rupert Bullock moved from the RCMP Commercial Crime Squad (where he had dealt extensively with the Office of the Superintendent of Brokers) to become Superintendent of Brokers, Real Estate and Insurance. He told us that on assuming his new position he was unable to find job descriptions for either himself or his staff (he later wrote some) and found no budgeting system in place.

An audit report, prepared by the Comptroller-General for the 15-month period from December 1977 to March 1979, agreed with Mr. Bullock's findings as well as the conclusions drawn by the Project Definition Report prepared for Mr. Irwin. It found (1) an absence of clear definitions of responsibility, division of duties and proper supervision, exemplified by informal, orally transmitted procedures and policy directives; (2) an absence of control over the pre-numbered annual licences issued to real estate, insurance and brokers' agents, with about 2,500 issued licences for 1977 and 1978 for which there was no record, and many unused licence forms lying about the office without proper safeguards or security; and (3) lack of participation by the Superintendent in the drafting of budgets or detailed review of expenditures.

Mr. Bullock was particularly concerned about the office's *Securities Act* policies, which he began to review and amend. He estimated that a quarter of his time in his first few years as Superintendent was spent attending national hearings and meetings on the securities industry. In addition, the necessity of renewing about 25,000 licences each year made it apparent to him that computerization of the office's records was essential. He assigned his Deputy Director of Registration to coordinate the computerization program. The Director of Registration, while retaining his title, was seconded in 1982 to a project the purpose of which was to organize the disposal of outdated documents. The Deputy Director of Registration became Acting Director and remained in that position until 1985.

Mr. Bullock reorganized the Investigations Department, and H.A. Dilworth became Director of Investigations in July 1982. Mr. Dilworth told us that on his arrival he was distressed to find a lack of procedural manuals, inadequate staff, and budget restrictions which impaired his ability to attract more qualified staff. He noted that staff were doing the best they could with inadequate resources.

Staff Shortages

Most of the Superintendents we examined referred to a lack of adequate staffing in the 1970s and 1980s. Shortly after becoming Superintendent, Mr. Bullock wrote to the Assistant Deputy Minister of Consumer and Corporate Affairs, Tom Cantell, saying that without more money and increased staff he would be unable to properly discharge his responsibilities. The situation was exacerbated, in Mr. Bullock's opinion, by the introduction in the spring of 1983 of the government's restraint program. He said the result was that positions became empty when staff left and new positions were filled by relatively unqualified people, due to policy directives requiring hiring from within the public service.

In October 1983 Mr. Bullock wrote to Assistant Deputy Minister of Consumer and Corporate Affairs J.D.N. Edgar, pointing out that the volume of filings had increased by almost two and one half times during the past year and a half. In January 1984 he notified Mr. Edgar of a tremendous backlog due to staff vacancies and the effects of the recent public service strike. Mr. Edgar told us that he did his best to represent Mr. Bullock's needs to his superiors, but "the problem was that we did not get, in my opinion, sufficient recognition at the Treasury Board level of the needs in those areas ... presumably because of all the other competing needs for dollars". Deputy Minister Jill Bodkin told us that in dealing with Treasury Board she would try to persuade them that the potential for failures of financial institutions was a very important reason to adequately fund the Superintendent of Brokers' office. While staffing was not increased, she felt that she had been able to spare further cuts in the Superintendent of Brokers' office.

The office attempted to decrease its growing workload with three procedural revisions. In 1983 the Superintendent implemented a change by issuing the majority of licences for two-year rather than one-year periods (except for investment contract company licences, which continued to require annual renewal). In 1985 the responsibility for the processing of the licences for companies such as those in the insurance and real estate fields was passed on to self-regulating organizations such as the Insurance Council and Real Estate Council. Earlier, registration application forms were merged in a "Uniform Application for Licence, Registration or Approval" to simplify and expedite processing. The use of this form was extended to include applications for renewal from AIC and FIC in 1984 although the *Investment Contract Act* required the submission of a different form.

Senior Management Turnover

In the summer of 1985 the Acting Director of Registration and Records left her position. She described to us the frustration she felt at being given ever-increasing responsibilities with inadequate staff to undertake them. On her departure, the Acting Deputy was promoted to Deputy and fulfilled the position of Acting Director as well.

Also in the autumn of 1985, Mr. Bullock submitted his resignation, to be effective in January 1986. At that time Deputy Superintendent of Brokers

Earl Jewitt, who was within a few months of retirement, became Acting Superintendent pending the hiring of a replacement. When Mr. Jewitt retired on May 31, 1986, J.D.N. Edgar, the Assistant Deputy Minister of Consumer and Corporate Affairs, filled in as Acting Superintendent during the three weeks before the candidate chosen by the search committee assumed his position as Superintendent on June 23.

Deputy Minister Jill Bodkin told us that, in seeking a replacement for Mr. Bullock, she had been looking for someone who would come in and "bring a good sound administration into that office". The person selected, Michael Ross, told us that when he came into the position he saw himself as a short-term Superintendent whose purpose was

> to get the place organized, get them on purpose, know what the real products and purposes of that branch would be, and start to measure that productivity in an appropriate way so that the market worked, so that the legislation was appropriately administered, and so that when I left there would be a sufficient framework and organization, budget allocation and design plan so that whoever walked into my job at whatever point in time wouldn't have too tough a time of it.

During Mr. Ross's superintendency, in November 1986, the Ministry of Consumer and Corporate Affairs was dissolved and the Superintendent of Brokers' office was moved under the corporate side of the new Ministry of Finance and Corporate Relations, with the Superintendent continuing to report to Assistant Deputy Minister J.D.N. Edgar. About the time of Mr. Ross's resignation, in February 1987, the B.C. Securities Commission came into operation under the chairmanship of Jill Bodkin.

Between February and June 1987, a time of mounting concern over the financial condition of AIC and FIC, the Acting Superintendent was David Sinclair. Mr. Sinclair, a senior chartered accountant and managing partner with a large national accounting firm, had been persuaded by Finance Minister Couvelier to fill in until a permanent replacement for Mr. Ross could be found. Mr. Sinclair served as Acting Superintendent for just over three months.

Neil de Gelder, who was chosen to replace Mr. Sinclair, described to us the situation awaiting him when he became Superintendent of Brokers on June 1, 1987:

> I don't know what kind of situation Michael Ross inherited so it's very difficult for me to say he started with this and then ended up over here. I frankly don't know what he accomplished in terms of reorganizing the office. If there was a sound and rational organizational structure that had been implemented either I didn't see it or it disappeared by the time I got there. And I didn't see myself as a management consultant or someone in there to reorganize. It was the first of many surprises I got, that the office didn't seem to have a rational structure and clear lines of authority...

Division of Responsibilities

The Registration and Records Department

In 1972, the Registration and Records Department consisted of a Director and a registration clerk. Over the next 15 years, as markets expanded and the Superintendent of Brokers' office took on the additional responsibilities for the regulation of the real estate and insurance businesses, the staff grew to over 30 persons. It is not clear to whom the Director of Registration reported during the 1970s. However, by 1981, job descriptions on file indicate that the general supervision of the department lay in the hands of the Deputy Superintendent of Insurance and Real Estate, while in matters related to securities (including investment contract companies), the Director reported to the Deputy Superintendent of Brokers.

Excerpts from the job description signed by the Director in 1978 provide an indication of the responsibilities:

> The Director ... directs staff engaged in the screening of applications for and the completion of registration procedures of companies and individuals applying for registration or licensing in the securities industry, mortgage brokerage, real estate and insurance fields.
>
> He will be responsible for the complete and proper evaluation and maintaining complete documentation relative to registrants, including highly confidential and sensitive material, utilizing any such information to determine eligibility for registration or as a basis for administrative action, as required. He will be expected to maintain constant supervision over the ethics and standards set for registrants and ensure strict adherence thereto...
>
> The Director will oversee the operation of a section comprising some 22 employees, enforcing policies and orders as set out and ensuring compliance with the statutes and regulations involved...
>
> [He will] ensure that registration procedures as laid down under the Statutes are complied with, that conditions of registration as ... set out are adhered to and that registrants in all categories conduct their affairs in the best interests of the public.

The *Investment Contract Act* and its regulations set out the manner in which a company was required to apply for registration or renewal of registration, submitting prescribed application forms and meeting certain conditions necessary for approval of registration. On receipt of an application, the Superintendent was to grant registration or renewal of registration "to an issuer where the applicant is suitable for registration and the sale of investment contracts issued by it would not tend to be a fraud on buyers of the contracts" (s. 9(a)).

Other sections of the Act provided direction regarding the conditions to be met to satisfy the requirements of section 9(a). Section 3(1) required the filing of the form of any investment contract to be offered for sale. Section 5(1) set conditions regarding the filing of specified company documents, minimum amounts of capital, and the deposit of qualified assets with a savings institution or other depositary. Section 10 required issuers to maintain sufficient reserves to be able to meet future commitments to pay matu-

rity values of investment contracts. It also provided for the Superintendent's approval of maximum rates of interest to be used in calculating reserve amounts. Section 17 required the filing of quarterly and annual financial statements within specified time periods.

Our examination under oath of current and former officials of the Registration Department revealed a variety of opinions — and some uncertainty — about where in the office responsibility lay for ensuring compliance with the sections of the Act referred to above. For example, neither the Director of Registration and Records nor his Deputy Director (later Acting Director) thought it was the Registration Department's responsibility to see that companies submitted copies of their forms of investment contracts (analysis of which was necessary to help the Superintendent determine whether the sale of contracts would tend to be a fraud). They were unsure whose responsibility it was. Another former Deputy Director thought the onus would have been on the companies themselves, as the office would have no way of knowing when forms changed. The records on file at the Superintendent's office do not indicate whether AIC and FIC filed their forms of contract regularly.

The statutory provisions referred to above and the wording of the Director's job description suggest that prior to renewing a company's registration, the Registration Department would have been expected to ensure that a company was "suitable" such that (1) any form of investment contract currently used by a company was on file in the Superintendent of Brokers' office, (2) quarterly financial statements were filed on time, and (3) audited annual financial statements were filed on time. Chapters VI to X discuss the actual practices of the department in processing the annual applications for renewal of registration by AIC and FIC.

The Financial Filings Department

Earl Jewitt joined the Superintendent of Brokers' office as Chief Accountant in 1966; by the late 1970s his title had changed to Director of Filings, and he held that position until 1979, when he became Deputy Superintendent of Brokers. His successors as Director of Filings included E.F. (Bill) Smith (briefly the Acting Director in 1980), another Director (1980-81), and then E.L Affleck (1981-87).

Originally, the review of financial statements was the responsibility of accountants in the office who "inherited" companies on an informal basis. Mr. Jewitt told us that he and the accountants he supervised were responsible for reviewing prospectuses, rights offerings, and other kinds of offerings that came into the office. Mr. Irwin suggested that Mr. Jewitt had the responsibility of allocating financial files in order to ensure an even distribution of work. However, Mr. Jewitt told us that he did not remember ever being advised what his responsibilities were with respect to investment contract companies.

The job description signed by Mr. Affleck shortly after he became Director of Filings in 1981 stated that the Director "monitors and directs the

vetting of filings under the *Securities Act, Mortgage Brokers Act* and *Commodities Act*". No mention was made of the *Investment Contract Act*. When asked how financial documents for investment contract companies came to be reviewed, Mr. Affleck told us that they were referred to the Registration Department.

The filing of financial statements was specifically required by the *Investment Contract Act* and was necessary for the continued monitoring of companies' financial condition to determine whether they were "suitable" for registration. Both Mr. Jewitt and Mr. Affleck considered it to be the responsibility of the Registration Department to ensure that audited annual financial statements and quarterly financial statements were filed by the companies. The Director of Registration from 1972 to 1986 told us that in his view the Registration Department was not responsible for ensuring that quarterly statements were received. This divergence of opinion was significant because AIC and FIC did not file quarterly statements on at least one occasion, and appear to have filed none at all between March 1979 and June 1984.

The Investigations Department

Prior to 1978, there was an investigations office in Vancouver under the supervision of a Chief Investigator who reported to the Deputy Superintendent of Brokers in Vancouver, while certain complaints of a minor nature were handled in the Victoria office, frequently by the Director of Registration.

After the relocation to Vancouver in September 1978, the Chief Investigator supervised several investigators and inspectors. The investigators, who were often former RCMP officers, had charge of the files and carried out investigations. The role of the inspectors, who were generally trained in accounting, was to analyze the financial information obtained by the investigators.

H.A. Dilworth, after becoming Director of Investigations in 1982, restructured the Department so that his Chief Investigator and Senior Inspector reported directly to him; they in turn each supervised a number of investigators or inspectors respectively. In April 1985 the Investigations Department was moved out of the Superintendent of Brokers' office and reported directly to the Assistant Deputy Minister of Corporate Affairs, J.D.N. Edgar. Its role was then expanded to provide investigation services to all regulatory offices operating under the Consumer and Corporate Affairs Ministry.

Mr. Dilworth's 1985 job description indicates that his role as Director of Investigations was essentially to provide investigative and analytic support to, among others, the Superintendent of Brokers. He was to "provide a strong preventative, detection and enforcement program to ensure the protection of the investment community and the public". It was his responsibility to make available to the Superintendent the information required to make a regulatory decision affecting a company's manner of operation.

Mr. Dilworth described to us the system used for initiating investigations. All complaints were recorded on a complaint sheet which was forwarded to the supervisor. Those complaints that he couldn't resolve with a phone call were passed on to an investigator. If an investigation uncovered a problem, Mr. Dilworth would flag the registration file with a computer entry that would alert any registration clerk pulling up the records that an investigation was under way. At that point it would be that clerk's responsibility to check with Mr. Dilworth's department before proceeding to renew registration. In this way, the other departments in the office became informed of activities of the Investigations Department.

Chapter IV

The Investment Contract Act

The *Investment Contract Act* came into force on July 1, 1962. Although there were a few later amendments, the basic provisions remained unchanged until the repeal of the Act on May 10, 1988. Pursuant to that Act, a company (called an "issuer" in the Act) issuing and selling investment contracts in British Columbia had to be registered by the Superintendent of Brokers. The Act required that the issuer file with the Superintendent certain documents that would allow him to determine whether the issuer was appropriate for registration.

Before proceeding to an analysis of the *Investment Contract Act*, it is worth noting that the regulatory scheme set up by the statute was not complicated. The companies were obliged to submit certain information to the Superintendent for his review and consideration. To guide him in this review the Act contained requirements—financial and other—by which the Superintendent could determine whether or not a particular company was suitable to sell investment contracts in British Columbia.

If a company met the requirements of the statute the Superintendent was obliged to register it. If it did not, the Superintendent was not obliged to register it. If the Superintendent was uncertain whether a company met the required tests, he had the power to secure further information. He also had the authority at any time to cancel or suspend a company's registration.

Obligations of the Issuer

A company seeking an initial or renewed registration had to follow certain application procedures prescribed by the Act. Section 7(1) of the Act stated that an application for registration "shall be made in writing to the Superintendent in the form and with a fee fixed by regulation". Along with this application and fee, the company was obliged to provide the Superintendent with an address for service in the province.

Application for initial registration required the filing of certain formal documents relating to incorporation and corporate officers as well as

> a certified copy of its balance sheet at the close of its last completed fiscal year, its auditor's report on the balance sheet and a copy of each form of investment contract proposed to be issued by it for sale in the Province.

Also the Superintendent had to be satisfied that the applicant met the financial requirements as set out in the Act in sections 5(1)(b), 5(1)(c), and 10. These requirements were intended to ensure that the companies had sufficient capital and "qualified assets" to be able to meet their obligations to their investment contract holders, and sufficient reserves to pay their outstanding investment contract liabilities.

The requirements for application for renewal of registration were straightforward and set out in section 8:

> A registration and renewal of registration lapses on the last day of March. A registered issuer or salesman desiring renewal of registration shall, before March 22, apply for renewal in the form and with the fee prescribed.

Along with the requirements for approval of initial and renewed registration, a company had continuing obligations. Section 3(1) of the Act required that:

> A copy of the form of an investment contract shall be filed with the superintendent before a person issues for sale, offers for sale or sells a contract, in that form.

Consequently, a company seeking to introduce a new contract for sale in the province had an obligation to submit that contract to the Superintendent, who was obliged to accept it "unless the sale of an investment contract in that form would tend to be a fraud on the buyer". This reasonably implied that a review of the form of contract was to be done by the Superintendent.

With regard to financial information, section 17(1) required that the companies submit, within 60 days of the end of each quarter, quarterly financial statements in a prescribed form and verified by the affidavit of two directors. Section 17(2) required that within 90 days of the end of a company's fiscal year, the company submit audited annual financial statements and "any other financial statements reasonably required by the superintendent". A regular review of these statements allowed the Superintendent to evaluate the company's financial position pursuant to the tests described in sections 5 and 10.

Finally, under section 21 a company was required to "notify the superintendent in writing of a change in its address for service or in its executive officers and the beginning and end of a salesman's employment, appointment or authorization".

If an investment contract company met the initial and continuing requirements contained in the *Investment Contract Act* as generally described above, it was entitled to be registered in B.C.

Obligations of the Superintendent: The Section 9 Test

Once a company had met the statutory requirements of the *Investment Contract Act*, the Superintendent was obliged by section 9 of the statute to grant registration or renewal of registration "where the application is made and fee paid in accordance with this Act" *unless* he was of the view that the applicant was not "suitable for registration" or that the sale of investment contracts issued by it would "tend to be a fraud on buyers of the contracts". Having analyzed the information about the company and its contracts, the Superintendent could decide to register an applicant for the upcoming registration year (from April 1 to March 31), after reasonably satisfying himself of the suitability of the applicant and that there were no facts of which he was aware that might reasonably indicate that the sale of its contracts would tend to be a fraud on the buyers.

Having granted registration or renewal pursuant to section 9, the Superintendent then had the power under section 13 of the Act to either suspend or cancel registration at any time "on any ground that would justify refusal of registration or renewal" or "where it *appears* from the statements and reports filed with him or from an inspection or valuation that the issuer will be unable to provide for the payment of its investment contracts at maturity" [emphasis added].

1. Elements Determining "Suitability"

Although "suitability" was not defined in the Act, there were three fundamental questions the answers to which would have helped a Superintendent determine whether an investment contract company was "suitable" for registration: (a) Was the company presently meeting its statutory filings obligations? (b) Would the sale of the company's investment contracts "tend to be a fraud on buyers of the contracts"? and (c) Was the company meeting the financial requirements imposed on it by the statute in terms of its capital requirements, qualified assets and reserves?

(a) Statutory Filings

These have been outlined above and obliged a company to file forms of contract pursuant to sections 3(1), corporate, financial and depositary information pursuant to section 5(1), financial statements pursuant to section 17 and information regarding changes in its address for service, corporate directors and salesmen pursuant to section 21. The financial statements required by section 17 are of primary importance. Without them, it would be impossible for the Superintendent to analyze the financial state of the companies, and determine whether or not a company was meeting the various financial tests.

(b) Suitable Contracts

This is an additional requirement under the second part of the section 9 test, which would not be met if the Superintendent determined that the sale

of contracts by a company might tend to be a fraud on buyers of the contracts. This, in itself, would be grounds for not registering a company either initially or on renewal. Later in this chapter we discuss what might tend to constitute a fraud upon buyers of the contracts.

(c) Financial Requirements

The methods by which the Superintendent could evaluate the financial compliance of an investment contract company with the requirements of the *Investment Contract Act* were reasonably straightforward:

(1) the company was required to submit financial statements to the Superintendent, pursuant to section 17, both quarterly and annually. The annual statements were to be audited in order to give some assurance that the amounts shown and the descriptions used were appropriate, in accordance with recognized accounting practices, the quarterly statements were to be "in a prescribed form and verified by the affidavit of two directors";

(2) the Superintendent could determine whether the company's method of valuing assets was in accordance with sections 22 and 23 of the Act;

(3) the Superintendent could then determine whether the company met the financial requirements of sections 5(1)(b), 5(1)(c), and 10. In this regard the statute provided three different financial "tests" which a company had to meet: the "capital" test (section 5(1)(b)), the "qualified assets on deposit" test (section 5(1)(c)), and the "reserves" test (section 10).

(i) The Capital Test: Section 5(1)(b)

Section 5(1)(b) stated:

> 5.(1) No corporation shall be registered as an issuer unless...
> (b) at least $100,000 of its authorized capital stock has been subscribed and paid in, in cash, and the aggregate of its unimpaired paid in capital and its surplus is at least $200,000...

Section 5(1)(b) required the Superintendent to analyze the equity position of an applicant for registration in order to determine that at least $100,000 of the authorized capital stock of the company had been subscribed and paid in, in cash and that the aggregate of its unimpaired paid in capital and its surplus was at least $200,000. As the term "unimpaired" is not defined in the Act the Superintendent was required to make a judgement as to whether or not certain assets might be disallowed for purposes of this test.

(ii) The Qualified Assets on Deposit Test: Sections 1 and 5(1)(c)

Section 5(1)(c) stated:

> 5.(1) No corporation shall be registered as an issuer unless...
> (c) arrangements satisfactory to the superintendent have been made to deposit, with a savings institution, or other depositary in Canada, qualified assets valued under sections 22 and 23 at not less at any time than the amount for which the corporation, under its invest-

> ment contracts, is liable at that time to pay in cash to the holders of outstanding contracts, or at a smaller amount believed by the superintendent appropriate.

For the Superintendent to assure himself that a company met the "qualified assets on deposit" requirement of section 5(1)(c), he needed to review the financial statements of the company in order to see whether or not the assets of the company met the definition of qualified assets as laid out in the statute. If he was lacking information about a particular asset he could request it from the company.

"Qualified assets" were defined in section 1 of the statute as meaning:

> (a) cash;
> (b) first mortgages on improved land and first mortgages made under The Dominion Housing Act, 1935 (Canada), The National Housing Act, 1944 (Canada), the National Housing Act [R.S.C. 1952] or the National Housing Act, 1954 (Canada);
> (c) securities authorized for investment under the Trustee Act or under the Canadian and British Insurance Companies Act (Canada);
> (d) land acquired under section 12; and
> (e) investments or securities designated by regulation.

In conjunction with satisfying himself that the "qualified assets" of the company met the definitions set out in section 1 and were reasonably valued, based on sections 22 and 23 if necessary, the Superintendent was required by virtue of section 5(1)(c) to ensure that he was satisfied with the company's depositary arrangements. This was to ensure that the company's "qualified assets" were available to meet the total cash value of outstanding investment contracts, as a form of protection for investors. Section 5(1)(c) allowed the Superintendent to accept a smaller amount where he considered it to be "appropriate".

In order to assure himself that a company met these requirements the Superintendent had to review the financial statements of the company and analyze them in terms of these requirements.

(iii) The Reserves Test: Section 10

Section 10 of the Act stated:

> (1) A registered issuer shall at all times maintain reserves to pay its outstanding investment contracts that, together with all future payments to be received by the issuer on those contracts, or the portions of those future payments still to be applied to reserves, and with accumulations of interest at an assumed rate provided in the contracts, will attain the face or maturity value specified in the contracts when due, or the amount payable under the terms of the contracts, or shall maintain reserves of a smaller amount deemed appropriate by the superintendent.
>
> (2) The reserves shall at no time be less than the amount for which the registered issuer, under its investment contracts, is liable to pay in cash to the holders of all its investment contracts then outstanding.
>
> (3) The assumed rate of interest to be provided in an investment contract under subsection (1) shall not exceed a rate approved by the superintendent, who may approve different rates for different forms of contract.

Although there is no requirement in this definition of reserves that requires them to be kept in any particular form of asset, in practice a company's reserves would have to be in "qualified assets" due to sections 5(1)(c) (just referred to) and 10(2). These would have to be at least equivalent to the total amount the company was presently liable to pay on its outstanding investment contracts. The responsibility of the Superintendent was to ensure that there were adequate reserves, as frequently as the company was obliged to file the required financial information. He had the discretion to approve lesser amounts of reserves as set out in section 10(1), as well as to approve different rates of assumed interest (section 10(3)) to be used in calculating reserves.

The reserve requirement in section 10(1) is the most basic protection provided to the purchasers of investment contracts. The higher the rate of interest allowed when calculating the reserve requirement, the lower the calculated reserve would be. A lower rate resulted in a higher reserve and hence greater protection of the investor. This placed upon the Superintendent of Brokers a responsibility to limit interest rates used in calculating reserve requirements.

Sections 5 and 10 were at the heart of the statutory scheme set out in the Act for regulating the sale of investment contracts in order to achieve the legislative objective of preventing unsuitable issuers selling investment contracts that would tend to be a fraud on buyers. The legislation was intended to prevent the sales of investment contracts by issuers with inadequate capital or insufficient qualified assets on deposit within sections 5(1)(b) and (c), or with inadequate reserves within the meaning of section 10. Suspected non-compliance with these mandatory provisions would be factors the Superintendent would have in mind when forming his judgement about whether the conditions of section 9(a) had been satisfied so that registration could issue or be renewed, and remain properly in force.

(iv) Valuation of Assets: Sections 22 and 23

While sections 5(1)(b), 5(1)(c) and 10 set out the financial tests which a company had to meet, sections 22 and 23 provided guidance for the valuation of the company's assets. Section 22 stated:

> 22. In any statement or balance sheet to be filed with the superintendent under this Act, an issuer may value its assets as
>
> (a) cash, in the amount in lawful money of Canada;
>
> (b) first mortgages, in the amount of balance of the principal sum secured together with unpaid interest accrued;
>
> (c) bonds, debentures and other evidence of indebtedness having a fixed term and rate of interest that are not in default on principal or interest and which, in the opinion of the superintendent, are amply secured at par if so purchased, and if purchased above or below par, on the basis of the purchase price adjusted to bring the value to par at maturity and to yield meantime the effective rate of interest at which the purchase was made, but the purchase price shall in no case be taken at a higher figure than the actual market value at the time of purchase;

(d) bonds, debentures and other evidence of indebtedness having a fixed term and rate of interest which are in default on principal or interest or which, in the opinion of the superintendent, are not amply secured at the market value at the date of the statement;
(e) stocks, at the book value, not in excess of the cost to the issuer and in the aggregate not in excess of the aggregate market value at the date of the statement; and
(f) other securities, at the book value but not in excess of the aggregate market value at the date of the statement.

If the information submitted by the company raised questions of inappropriate valuation, then those factors were also relevant to the Superintendent's determination with regard to an issuer's appropriateness for continued registration and whether or not the continued sale of its investment contracts would "tend to be a fraud on the buyers of the contracts".

Looking at each subsection, we note that the value in cash of the amount of lawful money of Canada under subsection (a) was self-evident. Valuing first mortgages in the amount of the balance of the principal sum secured together with unpaid interest accrued, while permitted under subsection (b), can be a risky way of valuing mortgages, in view of the fact that if the mortgage remains in default no interest will be paid, but the mortgage will be valued so as to include the amount of unpaid interest. However, section 23 gives the Superintendent the power to limit the recorded values of mortgages and loans to appraised values.

Subsection 22(c) dealt with valuing bonds, debentures and other evidence of indebtedness *that are not in default* in relation to either principal or interest. The Superintendent was to ensure ("in the opinion of the superintendent") that these bonds, debentures or other evidence of indebtedness were amply secured at the recorded values.

Subsection 22(d) referred to the same kind of instruments as in 22(c) with a fixed term and rate of interest which *were in default* either in relation to principal or interest or "which, in the opinion of the superintendent, are not amply secured". These were to be reduced to the market value at the date of the statement.

The stocks referred to in section 22(e) could be valued at the recorded value, as long as this was not in excess of what the issuer bought them for and as long as the aggregate value of the stocks did not exceed the aggregate market value as of the date of the statement.

"Other securities" referred to in subsection (f) were also to be valued at book value but not in excess of the aggregate market value as of the date of the statement.

Instruments which were to be valued in the way set out in section 22(c), (d), (e) and (f) had to be investments in which a trustee could invest his funds under section 15 of the *Trustee Act* or investments which were permitted under the *Canadian and British Insurance Companies Act* as set out in section 11.

Section 23 allowed for different valuation in special cases.

> 23. Where an asset consists of securities the market value of which is unduly depressed and in respect of which companies registered under the *Canadian and British Insurance Companies Act* (Canada) have been authorized to use values in excess of the market values, those assets may, with the approval of the superintendent, be valued as authorized under that Act; but if it appears to the superintendent that the amount secured by mortgage on a parcel of land, with interest due and accrued, is greater than the value of the parcel or that the parcel is not sufficient for the loan and interest, he may procure an appraisal of the land. If from the appraised value it appears that the parcel is not adequate security for the loan and interest, the loan or mortgage shall be valued at an amount not to exceed the appraised value.

This section had a similar thrust to section 22, but with an addition that considerably widened the scope of the Superintendent's review and discretion: the notion of "market value" obliged the Superintendent of Brokers to review the valuation of a company's asset portfolio and the effect which market variability could have upon it. This principle extended explicitly to both the securities and real estate markets. The volatile nature of securities and real estate markets should cause the Superintendent to pay special attention to the values placed on these assets in the financial statements. If quarterly and annual reports were filed in sufficient detail, there would be an adequate chronological valuation record to provide for some indication of potential losses and hence a potential reduction in available reserves.

As can be seen from the preceding, the only way the Superintendent could ensure that the companies were meeting the stringent requirements of the *Investment Contract Act* was to ensure that financial statements were coming in, that they were directed to a trained accountant, and that an appropriate analysis was performed.

2. Elements Determining "Tend to be a Fraud on Buyers of the Contracts"

The second test outlined in section 9 was the "tend to be a fraud" test. In order to determine whether or not the sale by a company of one of its investment contracts might tend to be a fraud on buyers of that contract one would need to look at four aspects of a company's operations: the financial state of the company, the nature of the contract being sold, the advertising of the contract, and the practices of the sales force.

(a) Financial State of the Issuer

As noted before, it was incumbent upon the Superintendent to analyze the financial state of the company to ensure that it could meet its liabilities to its contract holders. If it could not, and yet continued to sell investment contracts which promised a return which it could not meet, continued sales of these contracts would tend to be a fraud on the buyers.

(b) Form of the Contract

Section 3(2) stated that "the superintendent shall accept a form [of contract] tendered unless the sale of an investment contract in that form would

tend to be a fraud on the buyer". This subsection required the Superintendent to analyze the form of contract which section 3(1) of the statute required the companies to submit. He needed to understand the term, rate of interest, and how the contract was structured. The purpose was clear. The contract might have been misleading or imposed too onerous conditions upon the purchaser. Only by assuring himself that the contract was not misleading or unfair could the Superintendent satisfy himself with respect to section 3(2).

(c) Advertising of the Contract

Advertising did not have to be submitted to the Superintendent for his approval unless he requested it, pursuant to section 20. Section 20 stated:

> 20. The superintendent may at any time require an issuer or salesman to submit for review circulars, pamphlets, specimen contracts, application forms or other documents used by the issuer or salesman in selling investment contracts.

This was clearly an optional power of the Superintendent, which he could utilize either if he suspected the advertising was misleading or if he wished to ascertain whether or not what was being advertised accorded with what was being sold—i.e., whether the terms of the advertised contract matched the actual contract. If not, the sale of the misrepresented contracts would also tend to be a fraud on buyers of the contract.

(d) Practices of the Sales Force

Section 4(2) of the statute required that "no person shall offer for sale or sell an investment contract unless he is ... registered as a salesman". Section 9, as with the case of registration or renewal of registration of an issuer, stated that the Superintendent was obliged to renew the registration of a salesman "where the applicant is suitable for registration and the proposed registration is not objectionable". Presumably there were certain qualifications that a Superintendent would look to when considering whether or not to grant registration to an issuer or salesman of investment contracts.

Section 4(2)(d), however, allowed sales staff the option of choosing to be registered under the *Securities Act* rather than under the *Investment Contract Act*. After 1966, no sales staff of AIC and FIC contracts were registered under the *Investment Contract Act*, according to the information available from the corporate files of the Superintendent of Brokers.

The problem this presented was that the Superintendent of Brokers' office was not aware, when registering salesmen under the *Securities Act*, whether or not they were selling investment contracts. That being the case, there was no way the Superintendent knew who was selling investment contracts and could assure himself that these salesmen were properly trained and qualified to sell investment contracts.

Powers of the Superintendent

The Act granted the Superintendent three significant powers: the power to obtain information (section 19); the power to refuse registration (section 9); and the power to cancel or suspend registration (section 13).

1. The Power to Obtain Information

The Superintendent had several ways of gathering information, in addition to that required to be submitted by issuers in the application process, to determine whether a company should be or continue to be registered. He could demand further particulars from the companies (which he did in the early 1970s and 1986), he could carry out an inspection of the company's records pursuant to section 19, or he could hold hearings (which he did in the early 1970s). As the obligation on the Superintendent of Brokers was to determine whether or not a company was, or continued to be, appropriate for registration, it was his clear obligation to ensure that he had the information upon which to base that decision.

2. The Power to Refuse Registration

Where, in the opinion of the Superintendent, a company applying for registration or renewal was either not "suitable" or the sale of its contracts might tend to be a fraud on buyers, the Superintendent was empowered to refuse registration, as discussed earlier in this chapter.

3. The Power to Suspend or Cancel Registration

The Superintendent's power to suspend or cancel a company's registration was set out in section 13.

> 13. (1) The superintendent may suspend or cancel a registration on any ground that would justify refusal of registration or renewal.
>
> (2) The superintendent may suspend or cancel the registration of an issuer *where it appears from the statements and reports filed with him or from an inspection or valuation that the issuer will be unable to provide for the payment of its investment contracts at maturity* [emphasis added].

The preceding analysis reveals that the *Investment Contract Act* required the Superintendent of Brokers to fulfil a number of obligations before permitting an investment contract company to operate or continue to operate in British Columbia. These obligations necessarily required the Superintendent to conduct analyses of the financial state of a company seeking registration, and of its manner of carrying on business. The Act provided the Superintendent with guidance not only about what to do but also about how to do it. He was armed with broad powers to be used in the event that he found a company unsuitable for registration in the province.

Chapter V

The Regulation of Principal Savings and Trust Co.

Under section 9 of the *Investment Contract Act* the Superintendent of Brokers was to grant renewal of registration to an issuer "where the applicant is suitable for registration and the sale of investment contracts issued by it would not tend to be a fraud on buyers of the contract".

The cross-selling practices employed by the Principal Group of Companies theoretically complicated the task faced by the Superintendent in determining whether the statutory conditions imposed by section 9 were being met by AIC and FIC. As neither company had sales representatives after the mid 1970s, their contracts were sold by PCL employees, who were registered under the *Securities Act* rather than under the *Investment Contract Act*. However, the registration certificates issued to sales staff under the *Securities Act* did not state that they sold investment contracts. Because of this, the Superintendent could not determine from his records who was selling investment contracts in B.C. Therefore, in the absence of a specific complaint it would have been difficult for the Superintendent to determine if the manner in which contracts were sold would "tend to be a fraud on buyers of the contract". However, as investment contracts were often sold on or adjacent to the premises of PS&T, where PCL employees conducted their business, their sale was directly linked to activities of PS&T. Consequently, a determination of the suitability for registration of AIC and FIC required close communication with the Superintendent of Credit Unions, Cooperatives and Trust Companies, the agency charged with the regulation of PS&T. Only through such communication could the Superintendent of Brokers identify the practices by which AIC's and FIC's investment contracts were promoted and sold.

Misleading Sales Practices

When PS&T established an office in Vancouver in 1967, it provided the Inspector of Trust Companies with an undertaking that the trust office area used by the public would be occupied only by PS&T staff. This was in accordance with a general government policy discouraging the use of agents to sell the products of trust companies.

In 1969 it became evident that an agreement had been made between PS&T and FIC which allowed FIC salesmen to sell PS&T products. This fact concerned both the Inspector of Trust Companies, and the Superintendent of Brokers, Bill Irwin. Mr. Irwin wrote to the Chairman of the Alberta Securities Commission in August 1969 to express his concern that Principal Group newspaper advertisements were offering PS&T products for sale by FIC salesmen. In January 1970 the Inspector wrote to the Secretary and General Counsel of PS&T, reminding him that the practice was contrary to the provisions of the *Trust Companies Act* and demanding that it be discontinued. On February 16, 1970, the Secretary and General Counsel wrote back to the Inspector assuring him that FIC salesmen had been instructed not to do anything that would constitute an agency relationship with PS&T.

In a memo written on February 20, 1970, the Inspector of Trust Companies noted his concern that "the same counter staff handles inquiries and cash for both the Trust Company and the Investment Funds... What I am afraid of is that the Trust Company sign is the 'come on'". The concerns of the Trust Companies section were aired at a meeting between them and PS&T officers on February 27. On March 13 the Inspector summarized the commitments provided by PS&T following the meeting:

> (1) The prohibition of direct solicitation on behalf of the Trust Company by employees of the investment contract companies.
>
> (2) Where a client inquires about Trust Company certificates the employees will be permitted to refer him to a branch office of the Trust Company.
>
> (3) Provision for the exchange of information between the investment contract companies and the Trust Company regarding maturing contracts so that the Trust Company can take appropriate action.

A copy of this letter was sent to Mr. Irwin.

The Trust Companies section continued to be concerned that signs and displays on doors at PS&T offices might confuse customers about whose products they were buying, and that the danger existed of customers entering PS&T premises being steered by staff to purchase another company's product. In June 1971 an Inspector of Trust Companies approved the opening of a new PS&T office in Vancouver "on the strict premise that it will be for business purposes of the Trust Company only". In September 1972, the Trust Companies section demanded that the marquee of PS&T immediately be removed from "the glass beside the entrance door to the office which houses also Principal Group Ltd. and others". PS&T agreed to comply with the demand.

PS&T practically ceased doing business in the province in the mid 1970s. A January 1977 report by CDIC noted that PS&T

> still seeks high rate, high risk mortgages and looks for securities profits to compensate for, rather than enhance, earnings which should be derived from the more traditional areas of trust company operation. Administration charges levied by the parent company serve as a conduit to siphon off profits which might otherwise be retained and effectively inhibit the growth of the trust company as a self-sustaining entity.

Precisely the same concerns were expressed about the operations of AIC and FIC by Alberta and B.C. regulators in the 1970s and 1980s.

Use of Agents

In mid 1974 the Trust Companies section altered its policy to allow trust companies authorized to do business in B.C. to employ agents as long as they sold only that company's guaranteed investment certificates and were not registered with the Superintendent of Brokers' office. The loosening of the restriction fell far short of satisfying the goals of PS&T's parent company, PGL, as shown by an October 1977 letter from PGL to a member of the Trust Companies section expressing the hope that the *Trust Companies Act* would be amended "so as to lead to the situation where licensed salesmen may sell this company's products as is the case here in Alberta".

After J. Henry Thomas became Superintendent of Credit Unions, Cooperatives and Trust Companies in 1978, Kenneth Marlin,[1] the Secretary-Treasurer of PS&T and President of PCL, wrote to him requesting approval of an agency relationship whereby PCL would handle the sale of PS&T guaranteed investment certificates. This, he said, would ensure better financial planning for customers with a broad range of services and fast and accurate information about customers' Principal accounts. "This can best be achieved," he wrote,

> with our Principal Financial Centre concept whereby the trust company and on-line banking services are located in close proximity to but separated from the consultants who will provide the planning and consulting service to the customer.

Mr. Thomas sought the advice of the Acting Deputy Superintendent of Trust Companies, who noted the "trend toward a more liberal attitude toward the establishment by trust companies of agencies" and suggested that the right of inspection be included as a condition of approval. In January 1979 the Acting Deputy approved the appointment of PCL as "agents for the sale of Principal Trust GICs", having been assured by Mr. Marlin that a clear public distinction would be made between PS&T services and those offered by its associated companies, and that customers would be informed that PS&T GIC deposits were covered by deposit insurance within the limits stipulated by CDIC, whereas deposits made to all other companies of the Group were not so insured.

In October 1979 the Vice-President of the Marketing Department for PGL wrote to the Acting Deputy to describe the setup planned for new PGL

branches to be opened in Vancouver and Victoria with the Acting Deputy's approval:

> Each office has two distinct operations. One is the trust services of Principal Savings and Trust Company. The trust employees operate our on-line teller system and assist our clients with their chequing and savings transactions. This part of the operation is supervised by our Savings Supervisor.
>
> The second operation...contains our financial consultants. They are licenced sales representatives who market all the products of Principal Trust. These products include Principal Venture Fund, Collective Mutual Fund, Principal Growth Fund, Bond Fund, investment certificates of First Investors and Associated Investors and Principal Trust GICs.

The Acting Deputy told us that while the Trust Companies section did not like the proposed setup, "there's nothing in the law says you can't run two or three companies under the same roof . . . there was no legislation. . ." However, on November 2, 1979, Superintendent Thomas wrote to PGL's Vice President of Marketing to express his concern about the possibility of clients being confused by the different operations being conducted on the same premises. He warned that

> any evidence of a diversion of funds intended for the trust company to the funds operation, as well as a misrepresentation of the nature of insurance coverage, will result in serious consequences for the Principal Group.

Complaints about Cross-Selling Practices

Late in 1981 the Acting Deputy was contacted by an investor complaining that a salesman had discouraged him from investing in PS&T and steered him instead towards the Principal Venture Fund. The Acting Deputy wrote to J.M. Cormie of PS&T and warned him that further such complaints would lead to serious consequences. He expressed his suspicion, resulting from several other complaints having been brought to his attention, that "Principal Group investment consultants are slanting their advice in a manner beneficial to the Group and themselves, and not necessarily to the benefit of the client".

In response to a September 1983 complaint of a similar nature, the Superintendent of Trust Companies expressed to J.M. Cormie his growing concern that clerks employed by PS&T were not allowed to sell their own products, which had to be sold by PCL "consultants". He recommended that "what falls a little short of a 'bait and switch' tactic" be terminated, and concluded: ". . . should any complaint of this nature recur it will leave me no alternative but to recommend that your trust company be barred from doing business in this province". Mr. Cormie wrote back objecting to "the threatening nature" of the letter.

Superintendent Thomas wrote to Mr. Cormie again in January 1984 following receipt of a further complaint. He also wrote to J.D.N. Edgar, Assistant Deputy Minister of Consumer and Corporate Affairs, expressing his concern that "members of the public are lured to invest in securities which are not covered by insurance" and suggesting that Mr. Edgar consider hold-

ing a hearing with respect to PS&T's operations. Mr. Edgar replied that Mr. Dilworth of the Investigations Department had told him that the complaint appeared to be an isolated one. He asked Superintendent Thomas for suggestions about how to deal with the "bait and switch" tactic; however, neither Mr. Thomas nor Mr. Edgar were able to recall whether any further discussions took place.

Transfer of Mortgages from PS&T to AIC and FIC

The audited annual financial statements for 1983 for PS&T, signed by their auditors on April 19, 1984, noted that on March 23, 1984, AIC and FIC had tendered funds (in the amount of $23,245,130) to purchase PS&T's interest in jointly held mortgages and properties. Note 7 to the statements indicated that the value of these mortgages and properties was about four and one half million dollars less than what they were sold to AIC and FIC for. It followed that AIC and FIC lost the same amount through the transaction.

Although the Acting Deputy did not recall having seen these statements he thought he probably would have. He did not think he would have alerted the Superintendent of Brokers about it as the two offices operated in "watertight compartments".

Although no action was taken in B.C. regarding this transaction, it caused concern in Alberta, where the Superintendent of Insurance, Tewfik Saleh, wrote to Mr. Marlin, the president of AIC, on May 11, 1984, to suggest that the transfer of mortgages be immediately reversed. "We are very concerned," he said,

> that despite your expressed anxiety about the status of the mortgage and real estate portfolio of FIC and AIC, they have nevertheless purchased [PS&T's] share in the seriously troubled and overvalued portfolio. In our opinion, this transaction is prejudicial to the interest of FIC and AIC contract holders.

The transaction was not reversed, but a $11.3 million promissory note subsequently injected capital into AIC and FIC from PGL. This was the amount of the potential loss as calculated by the Alberta regulators. The B.C. regulators were not made aware of Mr. Saleh's concerns.

Concerns About PS&T, 1984–86

On June 11, 1984, Mr. Thomas, the Superintendent of Trust Companies wrote to the General Manager of PS&T in Alberta, again expressing his concern about the possible conflict of interest arising from the fact that trust company employees were required to refer all prospective guaranteed investment certificate purchasers to consultants of another company. A report to Mr. Thomas in July 1985, following an inspection of a Vancouver PS&T branch, indicated that the practice was still in place.

In November 1985 a citizen with several investments in FIC wrote to the Trust Companies section: "I heard a rumour that Principal might 'go down'... I am concerned as to the validity of this rumour and whether or not my investments are secure." The letter was forwarded to the Office of the Superintendent of Brokers. Deputy Superintendent Jewitt wrote to the complainant confirming that her investments were not guaranteed but noting that the company was registered "in good standing" in B.C.

In July 1986 a letter was sent from the Senior Trust Officer to a citizen whose letter had been forwarded to him by the Director of the Investigations Department, Mr. Dilworth. It stated that

> the reference to chartered Canadian banks by the Principal Group of companies, when selling their speculative funds, is misleading. It obviously is calculated to make you feel secure, when actually you are uninsured.

On August 11, 1987, following the cancellation of the licences of AIC and FIC, Registrar of Companies M.A. Jorre de St. Jorre suspended the registration of PS&T pursuant to section 71 of the *Trust Company Act* of British Columbia.

Chapter VI

The Regulation of AIC and FIC, July 1962 to September 1978

Proclamation of the Investment Contract Act

The British Columbia *Investment Contract Act* was proclaimed in July 1962. Its enactment was a response to the need for a mechanism designed specifically for the regulation of companies selling investment contracts, with which were associated risks of a different nature than those pertaining to products sold by other financial institutions. Chapter IV provides an analysis of the provisions of the Act, summarized in the following paragraphs.

The Act required companies selling investment contracts in B.C. to be registered annually by the Superintendent of Insurance (the Superintendent of Brokers after 1970), who was responsible for determining whether or not companies were suitable to be licensed. In order to make that assessment, the Superintendent needed to satisfy himself that a company applying for registration or renewal of registration was in a sound financial position according to certain criteria established by the Act. Investment contract companies were required at all times to maintain reserves sufficient to meet their obligations to holders of outstanding investment contracts. To ensure that such reserves were in a satisfactory form, the Act required companies to have on deposit with a Canadian savings institution or other depositary "qualified assets" equal to or greater than the cash surrender amount owed to holders of outstanding contracts. The Act specified a list of assets that were deemed acceptable as qualified assets, to ensure that investments made by investment contract companies were relatively conservative. Fi-

nally, no investment contract company was to be registered unless it met the minimum capital requirements specified by the Act.

To ensure that the Superintendent had access to the information he needed to determine that investment contract companies met the conditions described above, the Act required a company to file with him audited financial statements within 90 days after the end of its fiscal year and quarterly financial statements within 60 days after the end of each quarter. In addition, the Superintendent was empowered at all times to inspect "all books of account, cash, securities, documents, bank accounts, vouchers, correspondence and records of every description" of issuers of investment contracts and their sales staff.

The Superintendent was also required to satisfy himself, before approving registration or renewal of registration, that the sale of investment contracts offered by a company "would not tend to be a fraud on buyers of the contracts". To enable him to determine that this was so, the Act required companies to file with him a copy of the form of each investment contract offered for sale. Any investor who had bought a contract that had not been filed with the Superintendent was entitled under the Act to rescind the contract.

In addition, the Superintendent was empowered to deny registration to salespersons whom he did not consider suitable. To assist him in determining whether or not they were suitable, he needed to monitor their selling practices.

Regulation Prior to 1970

When the *Investment Contract Act* came into force, four investment contract companies were operating in B.C. They were AIC, FIC, and two other unrelated companies. The Superintendent of Insurance who regulated investment contract companies from 1962 to 1970 told us he could not recall receiving any complaints about AIC and FIC during the time he was responsible for their regulation. The records of registration documents for FIC during that period (no records for AIC could be found) show that virtually all applications for renewal were received on time.

Information released during the Code inquiry in Alberta revealed that as early as 1962 the Alberta Securities Commission had encountered problems with the companies which were similar to those which caused significant problems later on. They instructed FIC to reduce the concentration of its investments in mortgages. The Alberta Securities Commission also noted that AIC and FIC apparently failed to meet the requirements of the Alberta *Investment Contracts Act* in 1965 and 1966, and that money taken out of AIC and FIC by shareholders and through excessive management fees resulted in a significant shortfall of capital.

Report of the Canadian Committee on Mutual Funds and Investment Contracts

The Report of the Canadian Committee on Mutual Funds and Investment Contracts, prepared in 1969, identified for provincial governments across the country certain problems in the investment contract industry and proposed a regulatory system for their management.

The report noted that, unlike the products sold by other financial institutions such as banks and trust companies, investment contracts tended to be "unsought goods" that were aggressively marketed to low-income investors by commissioned salespersons. The high interest rates promised by the companies, combined with the unusually high commissions given their sales staff, increased the risk that such companies might be unable to meet contract obligations at their dates of maturity unless they generated an ever-increasing volume of contract sales. Consequently, noted the report, there was a need to ensure that legislation governing investment contract companies required them to maintain reserves which at all times had a value at least equal to the amount owed to contract holders. The report also recommended that, in order for adequate protection to be provided, such legislation specify not only the value but also the nature of the assets to be held as reserves. The B.C. *Investment Contract Act* contained the elements that the Committee suggested were essential for the protection of the investing public.

Disagreeing with industry submissions that companies should set their own reserve accumulation rates, the Committee recommended that that responsibility should remain with the regulators, as any other arrangement

> might cause serious problems, particularly in the case of an investment contract company which encountered financial difficulties and might be prepared to promise unrealistic interest rates in order to raise new money.

It further recommended a minimum capital requirement of not less than a specified dollar amount, for two reasons: to prevent the sale of long-term contracts by a company without adequate cash reserves, and "to provide an opportunity for action if an investment company encounters financial difficulties, before it becomes insolvent".

The report alerted governments to the risks caused by non-arm's-length investments, noting that

> a problem which has occasioned some concern among administrators is the investment of reserves in securities issued by companies associated with investment contract companies.

The report noted that "the crucial feature of an investment contract company is, in our opinion, the issuance of instalment investment contracts" and that companies issuing single payment contracts exclusively should not be treated as investment contract companies but should be regulated like trust companies or some other form of financial institution. By the early 1980s, AIC and FIC were primarily selling single payment contracts, a prac-

tice which the Robinson report found was designed to target consumers who were looking for safe, insured investment certificates and were unable to distinguish investment contracts from the guaranteed (CDIC-insured) investment certificates sold by trust companies.

The report concluded that, because of the risks inherent in the investment contract business, it was of the utmost importance that holders of investment contracts be entitled to receive regular reports concerning the financial condition of the issuing companies. In B.C., during the years that followed, AIC and FIC did not provide their investors with such reports, nor did the Superintendent of Brokers' office have a policy regarding what financial information they would make available to the public regarding investment contract companies. The purpose of the recommendations made by the Committee was to provide the federal and provincial governments with the means to avoid the negative consequences it associated with practices identical to those characterizing the operations of AIC and FIC in later years.

Regulation Between 1970 and 1978

Most records in the Superintendent of Brokers' office of regulatory action relating to AIC and FIC during this period were lost or destroyed by the early 1980s. To assist us in attempting to determine a partial sequence of events in the 1970s, we obtained documents from various sources in Alberta.

A review of regulatory action taken between 1970 and 1978 illustrates the distinctions between the approaches taken by regulators in the early 1970s and those employed by regulators in the decade preceding the collapse of the Principal Group. There were close parallels between the situations faced by regulators dealing with AIC and FIC in each decade. The same issues caused concern: valuation of assets, including securities and mortgages; the real value of non arm's-length asset transfers; the interdependent nature of companies in the Principal Group; and whether certain investments by the companies complied with the requirements of the *Investment Contract Act*. However, a regulator in the mid 1980s seeking information about events occurring earlier would have found virtually no records for guidance.

1. Registrations and Filings

On April 3, 1970, responsibility for the regulation of investment contract companies was transferred from the Superintendent of Insurance to the Superintendent of Brokers. On July 17, 1972, the newly created position of Director of Registration and Records came into being. The first Director told us that investment contract companies played a very small part in the office's operations, so much so that he wasn't aware for three or four years that the office had investment contracts among its filings.

Procedures and Responsibilities

In this Director's view the registration procedure was straightforward. The application for registration renewal would be forwarded to the registration clerk, and the audited year-end financial statements, which were required to be filed within 90 days of the end of the company's fiscal year, would be sent for inspection to the accountant responsible for monitoring the company. Once the accountant had approved the statements, the registration clerk would type up the certificate of registration, which was stated to be effective from April 1 to the following March 31 regardless of when the application was actually approved.

Earl Jewitt, the Chief Accountant (later retitled Director of Filings), and Superintendent W.S. Irwin told us that the policy of the time was that registration not proceed until the annual financial statements had been examined and approved by an accountant. However, this was not the recollection of L.G. Smallacombe, who assisted in the regulation of the companies, or of Bill Smith, who also had a hand in dealing with the companies during this period. They thought that a registration renewal followed automatically upon the filing of the required application and financial statements without an accountant's approval being needed.

We also found a variation of opinion on the question of whose responsibility it was to ensure that companies' financial statements had been received. The Director told us it was the responsibility of the accountants, not that of the Registration Department, to ensure that the quarterly but not the annual financial statements came in. Mr. Jewitt agreed, although Mr. Smallacombe stated that it was up to the Registration Department to see that both sets of financial statements required for registration were filed. Mr. Irwin suggested it would have been the responsibility of the Registration Department to notify the accountants or the Superintendent if financial statements had not been filed by the time the statutory deadline had passed.

Evidently no written guidelines existed regarding the procedures and responsibilities referred to above. Mr. Smallacombe told us that when he began to work with *Investment Contract Act* registrants in 1970, there was no policy in place. However, because the office was small and one accountant did most of the work with the registrants,this lack of policy did not cause problems at that time. The lack of uniformity in officials' interpretation of procedures and responsibilities was to continue until the end of the period covered by this report, as will become apparent through the remaining chapters.

Renewals of Registration

The renewal certificate for FIC's 1974-75 registration was typed on March 19, a month before Mr. Smith notified the Director of Registration (on April 25) that he was satisfied that registration could proceed. A complete listing of the registration and financial filings histories for AIC and FIC is presented in Appendices 5 to 7.

The Director told us that regardless of when renewal applications were approved,

> they were always backdated . . . to April 1, because the companies continued to sell until our requirements were met. It wasn't the policy of the office to stop the selling of securities simply because all of the requirements hadn't been met.

During each of the following years in this period, FIC's renewal certificate was typed either on the same day as or the day after the renewal application was received.

AIC's registration was renewed in 1971 and 1972. In 1973 AIC submitted an application but later asked that it be returned, after Superintendent Irwin wrote to the company informing it that its registration would not be renewed unless it took steps before March 31 to meet certain conditions to improve its financial condition. The company became registered again on January 26, 1978, part way through the 1977-78 registration year. This was effective until March 31, 1978. There was no information regarding AIC becoming reregistered in B.C. available in the files of the Superintendent of Brokers. Therefore, there is no way of determining what degree of review the matter received by the staff at the Superintendent of Brokers' office.

On May 2, 1978 AIC, applied for renewal of registration for 1978-79. The certificate was issued on May 5 and backdated to April 1, 1978, the beginning of the 1978-79 registration year.

The records on file for FIC indicate that the December 1972 quarterly financial statements were filed late, on March 16, 1973, and that quarterly statements were filed for the periods ending March 1977 through to June 1978.

2. Financial Regulation

Communication with Alberta Regulators

The person originally in charge of registration for the Superintendent of Brokers' office renewed FIC's registration for 1970-71. On May 27, 1970, he sent an extensive memorandum to Superintendent Irwin listing FIC's associates and affiliates registered in Canada and the U.S. and thereby describing its place in the Principal Group of Companies. Mr. Irwin, concerned that the group appeared to have "some of the same ingredients" as the Commonwealth conglomerate, which had recently collapsed, wrote to G.H. Rose, Chairman of the Alberta Securities Commission, to inquire whether Alberta had sufficient financial information to determine to what degree each of the entities in the group "leans on the other". Mr. Rose replied that he had long felt "spooky" about investment contract companies controlled by the Principal Group and said he would forward Mr. Irwin's letter to Jim Darwish, an auditor with the Alberta Securities Commission, for a response.

Mr. Darwish wrote to Mr. Jewitt on September 23, 1970, expressing concern about a draft investment contract form submitted for approval by AIC and FIC. He found objectionable the fact that the contract was for a 10-year-period, with no cash surrender value or loan value indicated, and that no statement of a promised rate of return was given either in the contract or the sales literature. He was also concerned that the companies were seeking approval of a higher reserve rate than was presently allowed, the effect of which would be to lower the amount of reserves available to cover contract liabilities.

Mr. Smallacombe, the accountant who participated in the regulation of AIC and FIC in the 1970s, said he received no training with respect to the requirements of the Act when Mr. Irwin assigned the companies to him. At first, he said, the office was more concerned with the forms of investment contracts than with the companies' financial statements. He would review the statements that came to him (in submissions to this office he stated that any difficult accounting questions were referred to either Mr. Jewitt or Mr. Smith as they were chartered accountants), but he thought it was the Director of Registration's responsibility to ensure that the statements were filed and that the Director would renew registrations automatically unless he was told not to.

If any major deficiencies were suspected in information provided by AIC and FIC, Mr. Smallacombe would usually contact the Alberta Securities Commission, on which, he said, the B.C. regulators were "fairly dependent" for information. Correspondence and telephone calls with Alberta resulted in a "huge file" on AIC and FIC in this period.

When he examined FIC's interim financial statements for the quarters ending in December 1969 and September 1970, Mr. Smallacombe was particularly concerned about the valuation of investments in mortgages, given depressed market conditions, and about the nature of notes receivable from the parent company, PGL, and its affiliates. On February 2, 1971, he wrote to Mr. Darwish of his concern that, had the companies used market values in their financial statements, their reserves would be considerably below statutory requirements. He asked Mr. Darwish to comment and to indicate "whether any action should be taken immediately".

Mr. Darwish provided a detailed response, indicating that the Alberta Securities Commission shared his concern about the companies' financial condition, and suggesting that Mr. Smallacombe write to AIC and FIC. This he did on February 23, 1971, asking AIC and FIC to provide detailed information about their investments and liabilities and to verify that companies to whom AIC and FIC had made loans were at arm's length with the shareholders of the Principal Group of Companies.

In response to a letter of March 15, 1971, received from FIC, Superintendent Irwin wrote to FIC to say he was "seriously concerned" about the financial condition of AIC and FIC and to ask for further detailed information. In particular, he questioned a loan of approximately $7 million on a project for which the total cost was approximately $4.3 million, inter-company share purchases, and several other related matters, including the valu-

ation of certain mortgage investments. On April 6 Mr. Callies of FIC replied, assuring Mr. Irwin that his concern was unwarranted and providing information about the four investments of concern to the B.C. regulators.

Another letter was sent to Mr. Irwin on April 6 by Mr. Archibald, the president of AIC and FIC, informing him of legal proceedings against AIC and FIC by a company in which it held investments. Mr. Irwin wrote back to Mr. Archibald demanding to be informed of the total principal amount of investment contracts outstanding in B.C. as at March 31, 1971. This demand, to which AIC and FIC responded, apparently represented the only time in the history of B.C. regulation that the companies were required to disclose the amount of their B.C. investment contracts. Mr. Irwin, in copying his letter to the Chairman of the Alberta Securities Commission, asked to be informed of any forthcoming meetings with AIC and FIC, and arranged to have Mr. Smallacombe attend the Alberta Securities Commission's hearing in Edmonton on April 26, 1971.

There followed a series of letters between the B.C. and Alberta regulators during the next month exchanging information about AIC and FIC. They indicate the care B.C. regulators took to ensure that they received as much information as possible from Alberta, and the willingness of Alberta to provide the material B.C. requested. The letters also discussed the Burton report (described below) on the companies which had been requested from an independent auditor by the Alberta Securities Commission following the April hearing.

The Burton Report

The independent auditor's report commissioned by the Alberta Securities Commission was prepared by A.G. Burton of Peat, Marwick, Mitchell & Co. and was dated June 11, 1971. Mr. Burton stressed the need for regulatory bodies to protect investors as well as the importance of flexibility in regulation in order not to stifle the business operations of investment contract companies. His conclusions regarding the operations of AIC and FIC included the following:

1. The reserve rate used by companies to calculate reserve amounts specified under the Alberta *Investment Contracts Act* should not be reduced as it would result in lower amounts held for the protection of investors.

2. AIC and FIC should not have obtained bank loans, because if the banks were to recall their loans, the collateral put up by the companies as security might have to be sold at a loss. He recommended that monies borrowed from banks not be included when calculating the amounts of qualified assets on hand.

3. The effect of inter-company transactions within the Principal Group was to splinter regulatory control. Therefore it might be advisable for the government to appoint one body with the power to examine all companies in the group to measure the solvency of the whole. Mr. Burton was critical of the interest-free advances that had been made by AIC and FIC to PGL

and proposed that "each company should provide its own funds for its own operations".

4. The companies should attempt to diversify their investments, restricting them to "what are normally deemed safe and secure ones, rather than the gambling type of assets which could produce large gains and also large losses".

5. The Alberta *Investment Contracts Act* should be amended to clarify and strengthen its requirements for investment contract companies and to ensure that the preceding recommendations were capable of being enforced.

Threatened Suspension of Registration

A series of letters between Superintendent Irwin and the Alberta Securities Commission between November 1971 and January 1972 discussed their concerns about the companies' financial condition and, in particular, a deficiency of qualified assets over statutory reserves and other liabilities which was evidenced in the September 30, 1971, quarterly reports. On March 6, 1972, Mr. Irwin wrote to both companies inviting them to show cause why their registrations should not be suspended, given the apparent fact that they would be unable to provide for the payment of their investment contracts at maturity.

On March 16, 1972, the companies applied for renewal of their registrations. The following day, Mr. Archibald, the president of AIC and FIC, wrote to Mr. Irwin attempting to allay his concerns by describing adjustments the companies were prepared to make in the valuation of their assets. The correspondence culminated in a hearing in Victoria on March 23, 1972. The records of that hearing are no longer available, but it would appear that the companies were able to satisfy the regulators of their viability, since their registrations were renewed the same day. Subsequent correspondence indicates, however, that the regulators were nonetheless left with a number of concerns about over-valued assets which they continued to monitor.

Monitoring of Valuation of Assets, April-September 1972

On April 25, 1972, as a follow-up to the hearing, Mr. Jewitt wrote to Mr. Archibald, President of AIC and FIC, expressing concern about the value placed on certain investments by AIC and FIC, and suggested that a "competent investment valuator", acceptable to the Alberta Securities Commission and paid for by the companies, be appointed to examine the investments. He sent a copy of the letter to Mr. Darwish of the Alberta Securities Commission with a covering note "concerning our mutual problem". Mr. Archibald wrote back to Mr. Jewitt in an effort to dissuade him. On May 30, however, Mr. Darwish wrote to Mr. Jewitt to agree with his proposal, adding that "I trust that together we will be able to iron out these problems".

Mr. Smallacombe's Report on AIC and FIC

One of the concerns of the regulators was the value of a debenture held by AIC and FIC which charged the assets of Marlin Management International Ltd. ("Marlin"). The debenture was apparently registered as a charge against a number of lots owned by Marlin in New Brunswick. The companies claimed the debenture was a qualified asset. AIC had had the land appraised first at $2,885,100, and then at $2,428,320, but both the B.C. and the Alberta regulators were sceptical about these values.

Mr. Smallacombe retained an independent appraiser and forced AIC to pay the bill. The appraisal suggested a value of only $450,000 in current market conditions. Mr. Smallacombe had also retained a New Brunswick lawyer to review the history of Marlin's financial dealings with the land. A series of title searches conducted by the lawyer made it evident that, over the course of a few months in the summer of 1972, the companies had either granted partial discharges of the debenture or had given up their own priority in favour of other financial encumbrances. The regulators had not been given any notice of these changes. The result was that the equity in the land was insufficient to secure the debenture.

Mr. Smallacombe also scrutinized other assets of the companies claimed to be qualified and prepared a detailed report for his superiors. As well, he sent copies of his report to the Alberta Securities Commission.

Mr. Smallacombe's work makes it clear that during this period, the Superintendent of Brokers' office was playing a very active role in the monitoring of AIC's and FIC's financial condition, and maintaining a close and ongoing liaison with regulators in Alberta.

On October 18, 1972, Mr. Smallacombe provided to Superintendent Irwin a very detailed report on the financial condition of AIC and FIC, focusing on deficiencies created by the actions of other companies in the Principal Group. He expressed concern about the fact that AIC's and FIC's parent companies, PGL and Collective Securities Ltd., (CSL) had purchased mortgages and had then transferred overvalued debentures to AIC and FIC in an attempt to create qualified assets that would fulfil the requirements of the *Investment Contract Act*. He described how AIC's and FIC's qualified assets were grossly overvalued because of unrealistic appraisals of questionable investments, resulting in a deficiency of qualified assets necessary to meet the cash surrender value of outstanding investment contracts as required by the Act. He concluded:

> Although we have treated these two companies separately we cannot disregard all the companies as a group, [as] all the deficiencies above have been created through the actions of Collective Securities Ltd. and Principal Group Ltd. If either of these companies are in default then it will reflect directly back to FIC and AIC...
>
> The above figures would indicate that these two companies are far from being solvent and would be in a dangerous condition if Collective Securities Ltd. or Principal Group Ltd. found themselves in financial difficulties.

In summary, Mr. Smallacombe's analysis focused on the financial dependency of AIC and FIC on PGL and CSL.

When the time for renewal of registrations for 1973-74 approached, Superintendent Irwin wrote to AIC and FIC on March 9, 1973, again putting them on notice that their registrations would not be renewed unless the deficiencies that had been identified by Mr. Smallacombe were rectified by March 31. Both letters were copied to the Alberta Securities Commission. Mr. Irwin pointed out that on the basis of Mr. Smallacombe's research during 1972, FIC had a deficiency of $1,722,147 with respect to reserves. AIC was calculated to have an equivalent deficiency of $2,058,676. The show cause hearing proceeded in Victoria at the end of March, 1973. The result of the hearing was that B.C. agreed to renew FIC's registration.

AIC, however, withdrew its application for renewal of registration rather than have on record a refusal to renew. On April 1 the company became unregistered and remained so for the next five years. FIC's renewal of registration certificate was mailed out to it on April 10.

The Weekly Summary of Corporate, Financial and Regulatory Services issued by the B.C. government for the week ending August 31, 1973, contained a notice that both AIC and FIC had had their registrations as Brokers in Mutual Funds discontinued and not renewed.

Exchange of Promissory Notes

In December 1973, Bill Smith, who was also handling the regulation of FIC for the Superintendent of Brokers' office at this time, wrote to both the president of FIC, Kenneth Marlin, and the company's auditors regarding his concern about an exchange of promissory notes between PGL and FIC. The apparent purpose of the exchange, according to the responses Mr. Smith received, was to shore up FIC's qualified assets, which had declined because of a slump in the value of FIC's stock portfolio, which FIC predicted to be temporary. The B.C. regulators were concerned about the minimal amount of security provided by PGL for the notes it issued to FIC.

On January 31, 1974, Superintendent Irwin wrote to Mr. Darwish, now the Superintendent of Insurance in Alberta, to say that he was concerned "that the transactions have not been at arm's length and that 'repayment' can take place at any time without the consent or knowledge of our respective jurisdictions". He suggested that

> it would not be out of the way to assume, with this group of companies, an immediate exchange of notes in advance of any decision to cease business, either for voluntary or involuntary reasons.

He suggested that both regulatory bodies demand that agreements to subordinate related party claims to those of investors in such transactions be filed with them and contain a provision similar to that in their standard form relating to such subrogation agreements, which required the company to obtain the regulator's permission before such amounts were paid off.

On the next day, by letter, Mr. Smith made the demand to FIC, that a $700,000 promissory note given by FIC to PGL be revised to include the clause:

> The Principal will not demand or accept payment of and the Firm will not pay to the Principal the said indebtedness or any part thereof until written permission is obtained from the British Columbia Securities Commission.

Mr. Marlin, in response, forwarded to Mr. Smith a letter of understanding between PGL and FIC to set out "the terms and conditions under which the note may be offset against the parent's notes". Mr. Smith wrote to Mr. Marlin on February 27, 1974, to say that

> we find the letter of Principal's to be in accordance with the general tenor of our conversation and our consent to release subordinated funds, all other things being equal, will follow the lines described.

However, Mr. Smith noted that Mr. Marlin's letter of understanding included no mention of the Securities Commission's consent being required prior to repayment of FIC's indebtedness. Consequently, when FIC applied for renewal of registration on March 15, 1974, Mr. Smith wrote to Mr. Marlin to say that no renewal would be considered until the subrogation clause that he had asked for had been submitted.

This letter, like Mr. Smith's earlier one, was copied to the Alberta Superintendent of Insurance. On March 22, 1974, an Alberta regulator noted on the copy: "Phoned Marlin and reminded him we want to be party to subrogation".

On March 22, Mr. Irwin formally notified Mr. Marlin that FIC would not receive its renewal until it provided not only the amended note but also an explanation of its valuation of certain assets. These included stocks which had been valued at other than cost or market values. For that purpose he ordered a hearing in Victoria on April 18, 1974. The day after the hearing, Mr. Smith wrote again to Mr. Marlin regarding requirements to be met before a registration renewal certificate would be issued to FIC.

On April 25, Mr. Smith notified the Director of Registration that FIC had satisfied B.C.'s requirements and that registration could proceed. The certificate was mailed out on May 9.

However, the B.C. regulators' concerns about FIC were revived on receipt of FIC's financial statement for the quarter ending June 30, 1974. Superintendent Irwin noted an amount of $316,738 owing by FIC to PGL and affiliated companies, and wrote that FIC's registration would be in "immediate jeopardy" unless FIC provided an assurance that a liability to the parent company would not be reduced and that further specified amounts of cash would be injected into FIC. The market value of the company's investments had dropped and the liability to the parent company had been incurred within the same period. Mr. Irwin required staged injections of capital, which he gave notice would be monitored. Subsequently, PGL provided debentures to FIC along with a subrogation agreement stating that

the indebtedness would not be repaid without the written permission of the B.C. Securities Commission and the Alberta Superintendent of Insurance. No information is available to indicate what further review of FIC's financial condition was done in B.C. following this action by FIC.

On October 1, 1974, the B.C. Securities Commission was replaced by the Corporate and Financial Services Commission, which was to have a broader appellate jurisdiction in the corporate and financial area.

Mr. Smith's Recollections of the Regulation of AIC and FIC

Mr. Smith recalled that the designation of responsibility for reviewing financial statements of investment contract companies was done on a rather informal basis. In the early 1970s

> somehow it came down to me that I was the one now doing it ... either Jewitt or I would be involved, probably up to 1975. I don't remember seeing them after that. They may have drifted down to some other person...

Mr. Smith said that when he and Mr. Jewitt were monitoring the companies it was "strictly from a financial statement point of view". When there appeared to be a problem, he or Mr. Jewitt would notify Mr. Irwin, and close contact was maintained with the Alberta regulators: "... if there was a problem we communicated with them. If they had a problem they communicated with us and we got it resolved".

Mr. Smith was not aware of a system to monitor the receipt of financial filings of *Investment Contract Act* registrants between 1969 and 1978. Nor was he aware that AIC and FIC contracts were being sold by salesmen registered under the *Securities Act* or that the Trust Companies branch had concerns about the involvement of PS&T with AIC and FIC operations. This may reflect the lack of any structured mechanism for inter-departmental communication.

There is no record of financial statements being filed by FIC in 1975, or any evidence of significant regulatory action in the 1975-76 registration year.

In January 1977 PGL notified the office of a proposal to change its practice so that investors wanting to purchase securities in more than one company in the Principal Group could, instead of paying each company separately, simply make payment to FIC, which would ensure that the payment did not become intermingled with its own funds. Mr. Jewitt advised PGL that he had no objection to the proposal as long as the Alberta Securities Commission approved of it. He told us he assumed salesmen would explain to clients what was occurring. However, the effect of the practice was to make it more difficult for investors to tell with whom they were dealing.

Mr. Smallacombe's Retirement

Mr. Smallacombe retired in February 1978. He told us he had kept a large file on AIC and FIC in his filing cabinet. The bulk of whatever records B.C.

had concerning the financial regulation of AIC and FIC could not later be found in the office.

Mr. Smallacombe recollected that AIC and FIC were hard to regulate. There were continuing and constantly varying irregularities in the business they conducted. As one of the primary persons who reviewed the financial filings of the companies, Mr. Smallacombe said his role was to check to see if the companies were financially viable. He said that he checked forms of investment contracts that were submitted to the office, but did not recall whether or not he advised complainants that, under section 3 of the *Investment Contract Act*, they could rescind a contract that was in a form that had not been filed with the Superintendent of Brokers' office.

Mr. Irwin told us that he did not recall who took responsibility for monitoring investment contract companies but that in his view it was up to Mr. Jewitt to allocate responsibilities for company files in order to ensure an appropriate work load distribution. Mr. Jewitt told us that he does not remember Mr. Irwin ever making him responsible for investment contract companies. Mr. Irwin continued to maintain a close liaison with the Alberta regulators, with whom he was in regular telephone contact during this period, and relied on them heavily as they were the "principal jurisdiction". He agreed that Mr. Jewitt might have received the idea from him that "If it is all right with Alberta, it's okay with us".

Departmental Reorganization

In January 1978 the Offices of the Superintendents of Brokers, Real Estate and Insurance were merged and in September transferred to Vancouver from Victoria. A memo from Deputy Minister Tex Enemark to the Minister of Consumer and Corporate Affairs noted that the ultimate objective of the merger and proposed restructuring of legislation was "to eliminate undue risks in the marketplace while limiting intervention of the government to a minimum".

Chapter VII

The Regulation of AIC and FIC, September 1978 to May 1984

The period following the transfer of the Superintendent of Brokers' office from Victoria to Vancouver in September 1978 saw significant turnovers in senior staff positions. In January 1980, W.S. Irwin resigned and was succeeded as Superintendent by Rupert Bullock. In December 1979, Earl Jewitt was promoted from Director of Filings to Deputy Superintendent. Bill Smith replaced Mr. Jewitt briefly as Director of Filings until the position was filled by a new Director, who left shortly after taking the position. Then E.L. Affleck became Director of Filings in the summer of 1981 and held the position until 1987.

In the Registration Department, the Director was seconded to a document disposal program in the office in the spring of 1982, and was replaced by an Acting Director of Registration who held the position until 1985.

1. Registrations and Filings

Missing Financial Statements

Although the *Investment Contract Act* required companies to submit financial statements both quarterly and annually, there are no financial statements on file for AIC at the Superintendent of Brokers' office for the period covered by this chapter; for FIC, there are only quarterly financial statements for September 1978 and December 1978. Whether the companies' financial statements were lost, destroyed, or simply never filed is unknown. After the December 1978 quarterly statements for FIC the next recorded financial statements for either company were the 1983 annual financial statements, received in May 1984.

Policies and Procedures

Mr. Dilworth, the newly appointed Director of Investigations, commented of the Registration Department during this period that some things were "slipping through the cracks" due to lack of organization. He told us the Department would send out letters to companies when financial statements were not submitted, but there was no follow-up. "I always attributed that to the fact that people just weren't telling these people what to do," he said. "I don't think they knew any better, or they didn't have a BF [bring forward] system."

No policy existed for the regulation of investment contract companies as distinct from registrants under the *Securities Act*. Superintendent Bullock told us he was not surprised to learn there had been confusion in the Registration Department about the requirements of the *Investment Contract Act*. He said that while the development of policy would have been a helpful step, it had not been a priority because while there were only a handful of investment contract companies, there were thousands of securities, real estate and insurance firms.

After 1978 financial statements for FIC were forwarded by the Registration Department to Mr. Jewitt. No one had been given the job of looking after the companies during this time, he said, but any statements that were submitted were sent to him. "I would check them over and say whether or not they were OK to renew or for filing or whatever the case may be," he told us. However, he did not consider himself the designated accountant at that time, and he did not become Deputy Superintendent of Brokers until December 1979.

The Director of Registration was responsible for ensuring "that registration procedures as laid down under the statutes are complied with", according to the job description he signed in 1978. Unlike Mr. Jewitt, he believed it was the responsibility not of the Registration Department but of the Director of Filings or the Deputy Superintendent to ensure that quarterly financial statements were filed as required by the Act. He said the first couple of years in Vancouver were chaotic, and he did not recall providing oral or written directions to his staff about specific registration procedures for investment contract companies.

The person who became Acting Director of Registration in 1982, when the Director was seconded to the document disposal project, agreed with Mr. Jewitt that it was the Registration Department's responsibility to monitor the receipt of financial statements. However, neither she nor her Acting Deputy Director believed that either the receipt of financial statements or approval of them by an accountant were necessary before renewals of registration were issued. This belief was contrary to that expressed by the Directors of Registration and of Filings.

The registration clerks between 1978 and 1983 said that they were unaware of any need to check whether financial statements had been received prior to issuing registration renewals, and did not do so. However, the person who became registration clerk in 1983 said, in contradiction of the

view expressed by the Acting Deputy Director and Acting Director of the time, that it was essential for audited annual financial statements to be submitted and approved by an accountant before she would issue a renewal of registration.

Registration Renewals

On May 1, 1984, the Acting Deputy Director of Registration wrote to both AIC and FIC pointing out that they were in arrears with respect to the filings required under section 17 of the *Investment Contract Act*. On May 16, the Superintendent of Brokers' office received the December 31, 1983, audited annual financial statements for both companies, although not the requested quarterly statements. These are the only financial statements of any description in the files of the office for AIC and FIC for the period between September 1978 and May 1984, with the single exception of FIC financial statements for the quarter ending December 31, 1978.

Registration renewal certificates were issued to AIC and FIC every year from 1979 through 1984. The registration clerks who issued the renewal certificates from 1979 through 1983 did not check whether or not financial statements had been received because they were not aware it was necessary to do so. The clerk who issued the renewal certificates in 1984 told us she would not have done so unless the companies' audited annual financial statements had been received and approved by an accountant. However, those statements were stamped "received" two months after the renewal certificates were issued for both companies and 36 days after the statutory deadline for the filing of those statements.

2. Financial Regulation

The records reveal no regulatory activity with respect to the financial viability of AIC and FIC between March 9, 1979, and May 1, 1984. As indicated above, there is no record of either annual or quarterly financial statements being submitted by either company during this period. The quarterly financial statements were critical indicators of the financial health of registrants, as they disclosed the amount required for reserves pursuant to section 10 of the Act as well as the value of qualified assets on deposit and total contract liabilities at the end of each quarter. The importance of quarterly financial statements is recognized by the requirement imposed by the *Investment Contract Act* that they be verified by the affidavit of two corporate directors. None of the quarterly financial statements on file at the Superintendent of Brokers' office met this requirement. This information was crucial to regulators seeking to determine whether investment contract companies were able to meet their liabilities to investors on a continuing basis, because this information was not contained in the annual financial statements.

The Alberta Superintendent of Insurance, Tewfik Saleh, grew increasingly concerned by the financial condition of FIC during this period, as evidenced by a letter he wrote to Kenneth Marlin, its President, on January

12, 1984. Mr. Saleh opened his letter by referring to his auditors' analysis of FIC for the year ending December 31, 1982. The auditors had identified deficiencies in both qualified assets and reserves required by the Alberta *Investment Contracts Act*, a capital impairment of $35.34 million, and an income loss of $4.3 million in 1982.

Mr. Saleh took issue with the use of subordinated notes with high interest rates which did not include a clause requiring the permission of the Superintendent for retirement of the notes. Mr. Saleh expressed concern as well about the $21.3 million in U.S. bonds and stocks which his office had been asking FIC to return to Canada for almost three years, without success. Finally, he noted the "disturbing figures" represented by significant mortgage investments and real estate foreclosures (56.5 per cent of FIC's assets were in mortgage and real estate, and almost half of its mortgage portfolio was on land under foreclosure) that had reduced the value of the company's assets.

Mr. Saleh found all of these above facts to be prejudicial to the interests of FIC's investment contract holders and in violation of the provisions of the Alberta *Investment Contracts Act*. He accordingly invited FIC officials and accountants to meet him and discuss his concerns. He did not advise the B.C. regulators of his grave concerns. In contrast to the early 1970s, there was little communication or coordination of efforts between regulators in the two provinces during this period.

Although there was no apparent monitoring by the B.C. regulators of the companies' financial condition during this period, significant concerns existed about the marketing practices employed by AIC and FIC, which were reviewed by the Investigations Department.

The Marketing of Investment Contracts

(a) Statutory Framework

Investment contract companies were required by the Act to submit their contract forms to the Superintendent, who could reject them (or refuse to register a company) if the contract described on the form would "tend to be a fraud on the buyer". To determine this, the Superintendent would need to compare the form with the companies' promotional and advertising material and to assess the companies' performance in the fulfilment of their obligations to existing contract holders.

In addition, the Superintendent had the authority to regulate the licensing of salespersons under the Act. Section 21 required issuers to notify the Superintendent at the beginning and end of a salesperson's employment. However, investment contract salespersons were also permitted to be licensed under the *Securities Act*.

Section 3(3) of the *Investment Contract Act* permitted an investor to rescind any investment contract the form of which had not been filed with the Superintendent. Our examination of witnesses indicated a general lack of

awareness of this provision, which may explain why investors who complained to the Superintendent of Brokers' office were not informed about it.

There appears to have been no policy with regard to making available to the public the forms filed with the office. While Mr. Bullock told us he thought they should be available to the public, Mr. Jewitt refused to provide them to a lawyer, saying they were not public information. However, in that case the lawyer was seeking the forms to use as precedents. Mr. Jewitt said he would have given a "yes" or "no" answer if an investor had asked whether a particular contract had been filed.

(b) Sales Offices and Products Sold

Members of the public who purchased investment contracts from AIC and FIC were subjected to several sources of confusion about what they were buying and who was selling it. Late in 1978, PGL had received permission from the Superintendent of Trust Companies to have PS&T products sold by PCL. PCL sales staff also sold investment contracts for AIC and FIC, and were motivated to do so by the fact that, in doing so, they received a commission that was significantly higher than the commission they earned for selling PS&T products.

Investors often mistakenly believed they were dealing with one entity instead of several. Investors who went to purchase a PS&T product were usually directed to meet with a PCL "financial consultant". Frequently these consultants encouraged potential investors to consider purchasing investment contracts through AIC and FIC.

Signs and displays on the premises increased the likelihood of confusion occurring. Reference was made to different products without differentiating between the companies selling them, and in some cases signs and displays simply referred to "Principal" without providing more specific identification of companies on the premises. AIC and FIC did not have separate premises, and the PCL salespersons who sold their products generally operated out of PS&T offices. As a result, many investors came to believe that the AIC and FIC contracts that they purchased were sold by PS&T, whose products were CDIC-insured.

(c) Insurance Coverage

In general, funds deposited with PS&T were protected by Canada Deposit Insurance Corporation insurance coverage to a maximum of $20,000 during this period (increased to $60,000 in 1983). AIC and FIC products were not eligible for this coverage and were not insured in any way.

Complaints to the Superintendent of Brokers indicated that some PCL salespersons told investors that the *Canadian and British Insurance Companies Act* provided insurance coverage equivalent to or better than CDIC coverage for their investment contract purchases. The *Investment Contract Act* provided only that securities authorized for investment under the *Canadian and British Insurance Companies Act* or the *Trustee Act* would constitute qualified assets as far as the requirements of the *Investment Contract Act* were

concerned. The only safety factor provided by this was the requirement that such securities be relatively conservative investments. This safety factor existed only to the extent that investment contract companies complied with the Act and invested in qualified assets.

(d) Types of Complaints

Many of the complaints to the Superintendent during this period focused on misleading information about "insured" investments. In the autumn of 1978, Superintendent Irwin ordered an investigation after being informed by an official with the federal Department of Insurance that a number of persons had complained that they had been told that their investments were insured under the *Canadian and British Insurance Companies Act*. Mr. Irwin forwarded a copy of the letter to the Alberta Superintendent of Insurance, Mr. Darwish, who confirmed that similar practices had been reported to him. In response to Alberta's concern, in 1978 Mr. Marlin, President of PCL, issued a directive to PCL sales staff instructing them to advise clients that CDIC coverage did not apply to investment contract companies but that AIC and FIC "guaranteed" the principal and interest, the safety of their investments being "assured by the quality of the investments permitted under the *Investment Contracts Act*". In spite of this directive, evidence presented to both the Robinson and Code inquiries indicates that the practice continued.

There were, as well, a number of complaints to B.C. regulators about misrepresentations regarding the rate of return on investment contracts. Promotional material advertised interest rates as high or higher than 11 per cent, and PCL salespersons were in the habit of telling clients this rate was guaranteed. However, the promised base rate of return set out in the contracts was usually 4 per cent, with "additional credits" being paid at the discretion of the directors of AIC and FIC.

A B.C. investigator in the Investigations Department who looked into this practice in 1980 concluded that it was fraudulent. He found no copies of the certificates guaranteeing 4 per cent interest on file, and recommended to the chief investigator that the companies be instructed not to distribute the certificates and be advised that the certificates would not be accepted for filing because of the misrepresentations that had been made about them. The Legal Department of the Ministry of Consumer and Corporate Affairs, on being consulted by Superintendent Bullock, confirmed that there may well have been fraudulent behaviour and that there was nothing to indicate that the certificate had been submitted, as required, to the Superintendent for approval. There is no evidence that any further action was taken by the office on the matter, and Mr. Bullock could not recall having seen the memorandum from the Legal Department.

Other practices led to a variety of complaints. The companies advertised their contracts as "guaranteed" investment contracts, although the guarantee depended entirely on the companies' ability to discharge their liabilities to investment contract holders. Other investors complained about the "bait-and-switch" tactics in which persons attempting to purchase CDIC-insured

PS&T products were steered by PCL salespersons to buy investment contracts. Some investors thought they had purchased RRSPs and then discovered they were unable to cash them without paying a cash penalty. Finally, there were complaints about the competence of PCL salespersons, one of whom persuaded an elderly woman to purchase a locked-in long-term investment.

Complaints received by the Superintendent of Trust Companies (who regulated PS&T) and by the Superintendent of Brokers were as a matter of course assigned for investigation to the Investigations Department. That department generally reported the results of its investigation to whichever office had received the complaint, although it appears there was no administrative structure in place to provide for the communication of information about complaints from one Superintendent to the other. In the event that his investigation uncovered problems, it was Mr. Dilworth's practice to "flag" the registration file. This took the form of an entry into the computer so that when a registration clerk pulled up the records of a company on the computer screen, she would see that an investigation was under way. At that point, it would be her responsibility to check with Mr. Dilworth's Department before proceeding to renew registration. In this way, the Registration Department was kept informed of any pertinent investigations being carried out by Mr. Dilworth's Department.

(e) Approval of Forms of Contracts

Many of the forms of contracts and application forms submitted by PCL, AIC and FIC for the scrutiny and approval of the Superintendent could be viewed as misleading. Some stated that the contracts were "guaranteed" when they were in fact only guaranteed by the companies themselves. Some forms were so written that it was difficult to identify clearly the company selling the product. For example, one application form referred both to AIC and FIC single payment plan investment certificates and to CDIC-insured PS&T term certificates. It also provided that the proceeds of the investments were to be deposited to a PS&T chequing account. Thus the confusion that many investors experienced as a result of the intermingling of premises and staff of the companies was often exacerbated by the terminology used on the application and contract forms.

The forms of investment contract were reviewed during this period by several regulators, including Mr. Irwin, Mr. Jewitt and the Director of Registration. Mr. Jewitt told us that it had been Mr. Irwin's policy, which he inherited, to rely on Alberta for approval of the forms, as the companies' head offices were located there. On a number of occasions Mr. Jewitt approved the forms on the condition that approval by Alberta be obtained, but in only one of the cases we reviewed did he require proof of that approval.

Management of the Investigations Department, 1982-84

On July 12, 1982, H.A. Dilworth took office in the newly created position of Director of Investigations and Inspections (previously the Investigations Department had been headed by a chief investigator). Mr. Dilworth quickly set up a structure under which all outgoing reports and mail, including interdepartmental memos, were to be channelled through him. In October 1982, after discovering that his department and the Filings Department had duplicated each other's efforts in an investigation because of lack of communication between the two, he issued a directive requiring his staff to provide to other departments any information obtained during an investigation that might be of use to them.

Mr. Dilworth expected his investigators to take responsibility for reading the *Investment Contract Act*. A complete set of statutes was kept in Mr. Dilworth's office, and investigators had access to legal assistance and Mr. Dilworth's attention whenever they required counsel.

Chapter VIII

The Regulation of AIC and FIC, May 1984 to May 1986

Rupert Bullock resigned as Superintendent of Brokers effective January 20, 1986, whereupon Earl Jewitt became Acting Superintendent. He retired at the end of May 1986, the same month in which the Director of Registration retired. In January 1986, E.L. Affleck became Acting Deputy Superintendent, replacing Mr. Jewitt and retaining as well his position as Director of Filings.

1. Registrations and Filings

Staff Changes

The two new staff members involved in registration renewals during this period were the woman who became registration supervisor in August 1985, and a financial clerk hired in the summer of 1984 with the specific responsibility of ensuring that companies filed their financial statements on time.

The new registration supervisor told us she received a general training from her registration clerk. She was not aware of any policy regarding the handling of investment contract companies.

Monitoring of Quarterly Filings

On May 1, 1984, the Acting Deputy Director of Registration wrote to AIC and FIC informing them that they were in arrears with respect to the filings required under section 17 of the *Investment Contract Act*. The Act stipulated

that quarterly financial statements were to be submitted within 60 days after the end of each quarter and the audited annual financial statements were to be submitted 90 days after the year end. The companies, which at this point had not filed financial statements, responded by submitting their audited annual financial statements for 1983, but did not enclose quarterly statements.

On May 29, 1984, Mr. Jewitt wrote to Tewfik Saleh, Alberta's Superintendent of Insurance, that his office had just discovered that it had no quarterly financial statements on file for either AIC or FIC for the past five years. Mr. Jewitt told us that he also did not think either company had submitted audited annual financial statements during those years. He told us that the probable reason why the companies' apparent failure to file statements had previously remained unnoticed was that no one at the Superintendent of Brokers' office had been given the specific responsibility of ensuring that their statements were received and reviewed during that period.

The Acting Director of Registration at the time told us she believed that the computer system set up in 1982 originally contained a method of tracking quarterly reports, but that this was deleted after a few months because so few companies registered with the office were required to file them. Mr. Jewitt's discovery led to the introduction of a computer-prompt system under which diary dates entered by the registration clerk would generate a reminder on the day a quarterly statement was due. The registration clerk told us that, under the new system, she would write to companies who failed to meet the deadline and would report to the registration supervisor if no response was received within 15 days of her letter.

On June 1, 1984, the registration supervisor wrote to AIC and FIC demanding their overdue financial statements for the quarter ending March 31, 1984. These quarterly statements were received on June 16, seventeen days after the statutory deadline.

The June 30 statements arrived on time. On October 18, the new prompting system operated prematurely, when the Acting Deputy Director wrote to AIC and FIC 41 days before their September 30 statements were due, requesting that they be submitted if the companies wished to maintain their registration in good standing. The statements were submitted a week later, and again at the end of November after the registration clerk, apparently unaware that they had been received, wrote letters on November 2 and again on November 16 demanding statements.

A similar premature demand was made to FIC for the December 1984 quarterly statements on February 6, 1985, under the name of the Acting Director of Registration. Those statements were never submitted. Nevertheless, the companies' registration for 1985-86 was renewed on March 18, 1985, after receipt of audited annual statements.

Both the March 31 and June 30 statements were demanded in a July 23, 1985, letter from the Acting Director of Registration. The March statements had been due May 30 and the June statements were not due until August 30. They were both received on August 15. The demands referred to above

were erroneously stated to be made pursuant to the *Securities Act*, rather than under section 17 of the *Investment Contract Act*.

On September 18, the Acting Director of Registration demanded the FIC March and June quarterlies, which had been received over a month earlier, and the companies submitted them a second time. Neither the September nor the December 1985 quarterly statements were submitted on time, but the Registration Department did not issue a demand until April 3, 1986, when they requested the September quarterly and 1985 annual statements although not the December quarterlies. The September quarterly statements were filed a week later. The December quarterly and audited annual statements did not arrive until June 10, 1986.

Registration Renewals

Although the December 1984 quarterly financial statements had not been filed, registration renewals for AIC and FIC for 1985-86 were issued by the registration clerk on March 18, 1985, after receipt of the 1984 audited annual financial statements. There is no record of the receipt of the December 1984 quarterly financial statements in the files we reviewed.

On July 11, 1985, the registration clerk wrote the following memo to Deputy Superintendent Jewitt: "Could you please make a notation on both financial statements [of AIC and FIC] for December 1984 if they are okay for renewal?" The registration clerk explained to us the reason for the memo by saying:

> I may have received the financial file back without a comment from Mr. Jewitt and may at times have had a verbal okay on the renewal. I'm ... asking him to initial, to have his official response to initial so we would have his approval in our files.

Mr. Jewitt responded to the memo:

> We're not very happy with the F/S submitted and have sent them to the Can Inst of C.A.s for their comments. In the meantime, we should accept their renewal.

When the March and June 1985 quarterly financial statements for FIC arrived for the second time in September, Mr. Jewitt sent them to Mr. Affleck saying they "did not look good" and asking for his comments. In response to a December 5, 1985, query about FIC from the financial clerk in the Registration Department, Mr. Jewitt wrote:

> No, we have not yet approved the financials for renewal. Ted Affleck is trying to obtain certain information from the auditors which has not yet been obtained.

Notwithstanding this memorandum to the financial clerk, Mr. Jewitt told us that he assumed that both companies were registered and in good standing at this time.

Renewal applications for 1986-87 were received from AIC and FIC on March 24, 1986. The following day, the registration clerk wrote to AIC telling it that its renewal would be delayed, pursuant to the *Securities Act*, because the Superintendent of Brokers' office required a "Form 4 for Petracca, Christa U. as Director of above company". On April 3, on being notified by the registration clerk that FIC and AIC had not submitted its 1985 audited annual financial statements, the Deputy Director of Registration warned the companies that if the statements were not received by April 21, "action may be taken which could affect your continued registration with this office". The companies responded by letter on April 7 enclosing the September 1985 quarterly financial statements, but not the annual financial statements. Mr. Marlin had written on March 31 to say that the statements would be delayed a few weeks.

2. Financial Regulation

Responsibility for Monitoring AIC and FIC

Mr. Jewitt told us that he had never been specifically directed by the Superintendent of Brokers to monitor companies registered under the *Investment Contract Act*, although after 1978, the Registration Department forwarded any financial statements received from FIC to him as he was at that time the Director of Filings.

Mr. Affleck told us his official duty was the administration of the *Securities Act* but that around 1984 he became involved with investment contract companies. However, he made it clear that he had never been asked to take over investment contract companies generally and would have resisted any such request because, following the introduction of the restraint program in 1983, "we were frightfully short of staff".

Mr. Jewitt told us that prior to the move to Vancouver in 1978, the Registration Department understood that it was to forward financial statements to the designated accountant. As there was no longer a designated accountant after that time, "probably the Registration Department sent them to me, because if they didn't know who to send them to, that's what they usually did".

Policies and Procedures

Mr. Jewitt told us that it was in his view the Superintendent's responsibility to develop policy regarding the duties of departments and individuals in the office. No policy had been developed with respect to the regulation of investment contract companies.

Mr. Bullock had not prepared policy directives specifically directed towards investment contract companies. There were extensive policies for securities regulation, and many of the general concepts were equally applicable to investment contract companies in his view. As well, development of policy regarding investment contract companies had not been a priority because they had been few in number.

Mr. Jewitt told us that when a deficiency was detected in a registrant's financial statement, the usual procedure was to send a memo to the Registration Department indicating what the deficiency was. That Department would then write to the registrant, identify the nature of the deficiency, and request rectification. However, Mr. Jewitt said that he handled AIC and FIC directly, as they were more complex than other companies.

Disclosure of Potential Shortfall in 1983 Annual Statements

In May 1984, Mr. Jewitt became aware that no records existed to indicate whether either company had filed any financial statements for the previous five years. This was brought to his attention after the Registration Department had notified AIC and FIC that they were in arrears and had received, in response, their audited annual financial statements for 1983.

Mr. Jewitt told us he did not require the companies to supply all their missing statements from the previous years because "I figured that I had the most up-to-date one, and that's really what I was after to see how the condition of the company was at that time". When asked whether it might have been important to see prior financial statements in case they contained auditors' qualifying notes, Mr. Jewitt replied: "Well, I suppose it's important, but it didn't occur to me." The 1983 annual financial statements contained 1982 comparison figures.

The 1983 audited annual financial statements gave Mr. Jewitt cause for concern. Prices in the Alberta real estate market, in which a large part of the companies' assets were invested, had plunged dramatically in 1982. Mr. Jewitt identified a potential shortfall of $17,793,114 for FIC and of $3,003,831 for AIC. On May 29, 1984, he stated this finding in a letter to the Alberta Superintendent of Insurance, Mr. Saleh, and asked to be provided with any information that "you feel would be of interest to us", noting that "if the companies were forced to sell their assets a much greater shortfall could occur".

Mr. Jewitt copied the letter to the Superintendent of Brokers, the Director of Investigations and the Acting Director of Registration. Unknown to Mr. Jewitt, in January 1984 Mr. Saleh had written to Mr. Marlin, the President of AIC and FIC, noting a capital impairment of $35.34 million for FIC, a significant deficit in the required amount of qualified assets, and unacceptable practices with respect to inter-company transactions, including injections of capital through secured promissory notes. In May 1984, following receipt of AIC's and FIC's 1983 annual statements, Mr. Saleh again wrote to Mr. Marlin requiring an immediate interim injection of $25 million for FIC and $10 million for AIC. The companies did not comply with this demand. Mr. Saleh apparently did not communicate these serious concerns to Mr. Jewitt.

Mr. Jewitt said that he discussed with Mr. Bullock the possibility of sending someone to Alberta to investigate, but "it seemed redundant for us to send someone there to do a job that was already being done".

Mr. Jewitt testified that in analyzing the 1983 financial statements he did not formally check them against the criteria set out in the *Investment Con-*

tract Act and other statutes referred to in that Act. He assumed the companies' Alberta auditors had determined that their qualified assets met the requirements of the Alberta *Investment Contracts Act*, which he understood were similar to the B.C. statute. He was "taking these statements as they stand and taking the market value or realizable value of these assets and comparing them to the assets that they have in their balance sheet". In doing so, he deducted from the companies' qualified assets certain debentures issued to FIC by PGL, because the transactions were not at arm's length. In 1986, however, promissory notes issued by the parent, PGL, to AIC and FIC were accepted by B.C. regulators as qualified assets. The Superintendent did not have any formal policy with respect to the assessment of qualified assets in general, or with respect to non-arm's-length transfers of assets alleged to be qualified, in particular. The result of this lack of policy was that it was possible for one regulator to reject a non-arm's-length asset transfer while his successor could accept it.

The 1983 annual statements for both companies noted that "it is the policy of the Company to provide an allowance against income to meet future general and exceptional losses arising from the Company's mortgage and owned property portfolio". In accordance with this policy, provisions against income for 1983 of $2.0 million for FIC and $0.7 million for AIC were made. In contingency notes to both the companies' financial statements, however, additional unrecorded exposures of $10 million for FIC and $3 million for AIC were disclosed. Mr. Jewitt told us that the notes

> indicate[d] to me that the method of valuing is a little strange. They're assuming that these [values of mortgages and property holdings] are temporary declines and that they will go back, which is possible but not necessarily so... It's a disclosure about there is this possible loss.

A further note on the FIC statements indicated that the company had paid $22,553,655 in cash to redeem the interest of PS&T in certain jointly held mortgages and owned property. In a related transaction on the same day, AIC had paid "an aggregate cash consideration of $691,475" to PS&T. CDIC had forced PS&T to divest itself of these mortgages as the recorded values were greater than their actual worth. PS&T did so, in effect transferring the "loss" to AIC and FIC inasmuch as it sold them at the "recorded" values. This issue is discussed in further detail in Chapter V.

Mr. Bullock did not recall taking any action after the possible shortfall indicated by the 1983 statements was brought to his attention. "Maybe it was done in such a way that the problem was about to be resolved or that something gave me comfort if I was given that information," he said.

Investigations Department Involvement

The Investigations Department was under enormous pressure during this period, according to Mr. Dilworth. He told us:

> I was working 70, 80 hour weeks... Some we hit dead on; others, hindsight's great... If you've got proper people, equipment, you can stop these

> things, but if you don't have it, it's do the best you can with what you've got... Everybody that was working for me was working like hell.

On receiving a copy of Mr. Jewitt's May 29, 1984, letter to Mr. Saleh, Mr. Dilworth forwarded it to a senior inspector in the Department, instructing him to "check these files to determine if they have an office etc. in B.C." The senior inspector discussed the problem with Mr. Jewitt. The inspector told us that Mr. Jewitt informed him that the assistance of the Investigations Department was not required, although Mr. Jewitt does not recall this. The inspector asked the Acting Director of Registration for particulars on the manner in which the companies were licensed in B.C.

On May 31, 1984, the senior inspector reported to Mr. Dilworth that the Acting Director of Registration had set up a new system to monitor future filings by the companies and that

> Mr. Jewitt does not contemplate using any inspectors for any audit purposes and at this stage he prefers to keep the companies going in order to protect the investors' interests. He did not seem concerned about the "new" investors.

After reviewing the senior inspector's report, Mr. Dilworth marked it to be brought forward in two months' time.

The file was brought forward on several subsequent occasions and resulted in a separate monitoring by the Investigations Department of Alberta's progress in the regulation of AIC and FIC. Mr. Dilworth said he did not believe he had the authority to dig into the AIC/FIC problem as he saw fit, because

> I had been told on a number of occasions that certain functions were for the Superintendent and it was none of my business. That may be because I was upsetting Superintendents by taking too active a role.

On subsequent occasions when the file was brought forward in the Investigations Department, a junior inspector who was assigned the file solicited information from senior Alberta regulators by telephone. It is not clear how much of the information thus obtained was passed on to Mr. Jewitt or Mr. Bullock, who Mr. Dilworth assumed "were probably talking to [Alberta] as well". Mr. Dilworth stated to us that, although he could not remember specifically, it was his practice to forward all relevant information to the appropriate official, who was in this case Mr. Jewitt.

On receiving a copy of the May 31 report from the senior inspector to Mr. Dilworth, which commented on Mr. Jewitt's view that it was in the interests of investors to "keep the companies going", Mr. Jewitt wrote to Mr. Dilworth:

> There are ... two points in this memorandum that I would like to put straight. In the first instance, I am concerned about the new investor, but that does not mean that we should close down an operation on a suspicion that the financial condition of a company is suspect. The Alberta Superintendent of Insurance is well aware of the situation, and I have relayed my

On March 5, 1985, the inspector called Mr. Rodrigues for an update. He reported by memorandum to Mr. Dilworth that Mr. Rodrigues told him that PGL had made a capital injection of $11.3 million to rectify the companies' deficiencies, that a $500,000 capital deficiency revealed in the 1984 audited annual statements had been corrected by a further cash injection, that the situation was "under control", and that the B.C. office would be advised of any adverse developments. However, the inspector told us he was left with the impression that the situation was deteriorating. The file was marked to be brought forward again on July 15, 1985.

The inspector sent a copy of his March 5 memorandum to Mr. Jewitt, as a result of a call the latter had made to him shortly after that date. Mr. Jewitt told us the capital injections revealed by the memo did not cause him concern because "I was happy to see that some money was being put in. Presumably it was cash." He made no further inquiries on the matter.

Mr. Jewitt recalled that he had telephoned Mr. Saleh or Mr. Rodrigues between August 22, 1984, when he first spoke to the inspector, and March 5, 1985. However, there were no notes or other documentation of these calls. Apart from an initial discussion in May or June of 1984, Mr. Jewitt could not recall talking to Mr. Bullock about the situation. The inspector's recollection was that he had not talked to Mr. Jewitt between August 22, 1984, and March 5, 1985.

On March 15, 1985, in response to a note from Mr. Bullock regarding AIC and FIC, Mr. Jewitt forwarded to him a copy of the inspector's March 5 memorandum and suggested that "we should continue a close monitoring of the situation". Mr. Jewitt told us that in his memorandum to Mr. Bullock, "in effect, I'm saying [the inspector] is monitoring them". Mr. Jewitt recalled that the Alberta regulators were seeking a legal opinion on the companies' compliance with the Alberta statute.

Review of 1984 Audited Annual Financial statements

When Mr. Jewitt wrote to Mr. Bullock on March 15, 1985, he also sent a copy of the inspector's March 5 memorandum to Mr. Affleck, along with the 1984 audited annual financial statements of AIC and FIC, requesting Mr. Affleck to review them.

On March 20, Mr. Affleck replied that he was greatly concerned about the fact that FIC had created a $10,190,000 "appropriation from retained earnings ... presumably as a means of compensating for a less than thorough P&L [profit and loss] provision for decline in market value of mortgages receivable and real property". He suggested the practice was "grossly misleading", as the appropriation from retained earnings greatly exceeded the amount of retained earnings available ($2,989,384). He told us he had never before heard of such a practice being used in a financial statement. He recommended that the matter be referred for comment to the Canadian Institute of Chartered Accountants. The practice was not addressed in the formulation of Generally Accepted Accounting Principles.

On March 26, 1985, Mr. Affleck expressed additional concern in a memorandum to Mr. Jewitt about a similar practice being used by AIC, which showed the creation of a $2.2 million appropriation from retained earnings when there was in fact a deficit in retained earnings of almost half a million dollars already. He asked if there was any suggestion that the Alberta Securities Commission might convene a hearing on the company's eligibility for continuing registration.

Mr. Jewitt was less concerned than he might otherwise have been about FIC's possible $7 million deficit because he understood there would be "a capital infusion or contemplated capital infusion in these same statements". There was a reference in the 1984 audited annual financial statements to the company's intention to convert $6.2 million of subordinated notes payable into share capital during 1985. (The 1985 FIC audited annual financial statements were to reveal that this conversion did not take place.)

On April 3, 1985, Mr. Jewitt wrote to Mr. Affleck that the inspector's March 5 memo showed that "the Alberta Superintendent of Insurance is now satisfied that the situation is under control because of the 1984 and 1985 capital infusions". However, he agreed with Mr. Affleck that it would be a good idea to forward the companies' financial statements to the Canadian Institute of Chartered Accountants for their comments.

Mr. Affleck told us he found the cash infusion referred to in the inspector's memo "startling". "They would inject everything ... but the kitchen sink," he commented.

On his copy of Mr. Jewitt's March 15, 1985, memorandum, Mr. Bullock wrote "file" and "hold". It appears that on June 26, 1985, Mr. Bullock's secretary requested an update from Mr. Jewitt, but Mr. Bullock told us he couldn't recall what the result was.

On July 8, Mr. Affleck wrote to the Accounting Standards Director of the Canadian Institute of Chartered Accountants, requesting any direction CICA might be able to give. CICA suggested that the Superintendent of Brokers' office communicate directly with the companies' auditors. On August 8, 1985, Mr. Affleck therefore wrote to PGL asking for an explanation of the appropriations from retained earnings. He copied his letter to the company's auditors, but received no written reply from either the company or the auditors and although telephone messages went back and forth, Mr. Affleck never did make contact.

Mr. Jewitt told us that he thought the appropriations from retained earnings were "not a serious point" and not one that would have led to a cancellation of registration. When asked whether anyone was making an effort to ensure that the companies were in compliance with the financial requirements of the *Investment Contract Act*, Mr. Jewitt told us:

> We were relying on Alberta to see that they complied with the [Alberta] *Investment Contracts Act*, which was similar to ours. As far as Alberta was concerned, they were complying. At least, that was the information.

> for practicality reasons such as the books were there,... all the real estate holdings were in Alberta, it would be very difficult...and expensive to go there and examine their records... The basic principle is that 'you look after what is in your jurisdiction and we'll look after what is in ours'.

Both Mr. Jewitt and Mr. Bullock agreed that the policy did not relieve the Superintendent of his obligation to ensure that the requirements of the *Investment Contract Act* were being met.

Mr. Affleck agreed that the theory of primary jurisdiction, while appropriate for securities regulation, was not necessarily so for investment contract company regulation:

> [Under] the *Securities Act*, if there is public trading it's generally through an exchange or through registered investment dealers... With these [investment contract companies], there is no sort of pooled market. They are each out doing his own thing.

Also, he recollected that Alberta was "a bit of a brick wall" when it came to sharing information. However, from a practical point of view, Mr. Affleck agreed that there was a need for cooperation between the provinces.

Mr. Jewitt agreed that if it appeared that the primary jurisdiction was not doing an adequate job in obtaining information, then the secondary jurisdiction had a responsibility to ensure that it obtained, of its own accord, the information necessary to assess companies' compliance with statutory requirements.

Mr. Irwin, the Superintendent of Brokers from 1962 to 1980, considered the theory of primary jurisdiction to be appropriate where assets were located in the province of primary jurisdiction. His practice, however, had been to take steps independent of Alberta, after consultation, if he thought the situation warranted it.

A senior inspector in the Investigations Department commented that while the theory was useful,

> the government has to have its own knowledge so that it can make a decision, whether it be to accept another jurisdiction's results or external auditors' results... I think the public is under the perception that they are protected by this government. Not by another government.

Chapter IX

The Regulation of AIC and FIC, June 1986 to February 1987

David Edgar, the Assistant Deputy Minister of Consumer and Corporate Affairs, held the position of Acting Superintendent of Brokers between June 1 and June 23, 1986, on which date Michael Ross took over as Superintendent. Mr. Ross left the position on February 2, 1987.

Deputy Minister Jill Bodkin told us that the appointment of Michael Ross as Superintendent was the result of a search for someone who could "bring a good sound administration into that office". Mr. Ross felt that his primary task was to get the office ready to administer the new *Securities Act* that was being prepared. He was very much aware of "an overriding concern for the ethics in the. . .securities industry".

In the administrative hierarchy, Mr. Ross had a reporting responsibility to the Assistant Deputy Minister of Consumer and Corporate Affairs, who was Mr. Edgar until July 14, 1986, when Deputy Minister Jill Bodkin was appointed to chair the Securities Commission, which was in the process of being created. Consequently, Mr. Edgar became Acting Deputy Minister and Maurice Jorre de St. Jorre, who was also the Registrar of Companies, became Acting Assistant Deputy Minister. It appears that Mr. Ross continued to report primarily to Mr. Edgar rather than to Mr. Jorre de St. Jorre after the transition, and informally to Ms. Bodkin throughout.

Shortly after his appointment, Mr. Ross met separately with Mr. Jewitt and with Mr. Bullock for briefing purposes, but told us he could not recall their having mentioned AIC or FIC. The *Investment Contract Act*, he noted, "was very short and said almost nothing. I can see why there was a view to just rolling [it] into the *Securities Act*, which seemed quite appropriate." He

could not recall seeing any written policies or procedures for the regulation of investment contract companies, and did not prepare any.

On June 1, 1986, the day that Mr. Edgar became Acting Superintendent, Mr. Bill Smith became Acting Deputy Superintendent, joining the Director of Filings, Mr. Affleck, who also held that position. On July 31, Mr. Smith left the office, resuming his previous position as a policy analyst with the Ministry of Consumer and Corporate Affairs although he would continue to be involved informally with AIC and FIC into 1987. On September 2, Gordon Mulligan began his employment with the office, having received a permanent appointment as Deputy Superintendent of Brokers.

On November 6, 1986, the Ministry of Consumer and Corporate Affairs was disbanded, and the Office of the Superintendent of Brokers was moved into the newly created Ministry of Finance and Corporate Relations.

1. Registrations and Filings

The registrations of AIC and FIC as investment contract companies had expired on March 31, 1986. Mr. Affleck told us he favoured putting a notice to that effect in the *Weekly Summary*, but Mr. Edgar told us it would have been premature without a hearing first being held or without close cooperation with the primary regulator, Alberta.

Within a few days of his arrival at the Superintendent of Brokers' office, Mr. Smith discovered that the 1985 audited annual financial statements had not been received when he pulled the companies' records to check the dates of their financial statements on file. He called Mr. Marlin, the president of AIC and FIC, who according to Mr. Smith seemed shocked to learn that the companies were not registered. On the same day, June 6, the Registration Department wrote to the companies to formally notify them that they were not registered. This was the first written notice to the companies of that fact, although AIC and FIC had been advised on March 27 that their registration would be delayed until one of the directors submitted a "Form 4" (which was not required under the Act), and the Registration Department had written to the companies on April 3 that deficiencies in their filings might affect their continued registration.

The annual statements arrived on June 9, 1986, seventy days after the statutory deadline, with a covering letter stating that rather than sending March 1986 quarterly statements, the companies would send them for the five-month period ending May 31. A duplicate set of annual statements arrived on June 10, apparently in response to the June 6 letter from the Registration Department, with a cover letter asking that Mr. Smith be informed that they had been received.

The Acting Director of Registration could not recall seeing the 1985 annual statements for AIC and FIC. She told us they would have gone to a registration clerk, who would have made an entry on the computer tracking system and forwarded the statements to "whoever was reviewing financials". Mr. Smith was not advised of the receipt of the statements. However,

he found out about them fortuitously when he happened to walk into the office of an accountant in the Filings Department. He told us:

> [I] asked her about her workload and...we had a little chinwag and she said, 'These two files have appeared. I don't know when I'll ever get to them. This is the AIC and FIC.' So I volunteered.

On June 20, while providing other financial information requested by Mr. Smith, Bill Johnson of PGL sent Mr. Smith financial statements for AIC and FIC for the quarter ending March 31, 1986, explaining that the statements had not been finalized until May, when the audit was completed. Mr. Johnson assured Mr. Smith that "the timely filing of the quarterly financial statements will take place from now on". The June, September and December quarterlies for both companies arrived on time.

Registration for both companies was eventually issued on August 28, 1986, on receipt of an indication of capital injections into the companies. The Acting Director of Registration and Records told us she asked Mr. Ross whether the registrations should be backdated, and on his instruction backdated them to April 1, 1986.

Draft audited annual financial statements for AIC and FIC for the fiscal year ending December 31, 1986, were received in the Superintendent of Brokers' office on January 21, 1987.

2. Financial Regulation

Bill Smith had dealt extensively with AIC and FIC in the mid 1970s as an accountant in the Filings Department of the Superintendent of Brokers' office. After the office moved to Vancouver in 1978, he remained in Victoria as a policy analyst with the Ministry of Consumer and Corporate Affairs. Mr. Edgar told us that Mr. Smith was seconded to the Superintendent of Brokers' office as Acting Deputy Superintendent because of an increasing number of complaints from the securities industry about chronic delays in the processing of prospectuses. Mr. Smith told us he was given no specific written or oral instructions on what his role was to be, and received no briefing on AIC and FIC. However, he soon became involved with the office's concerns about AIC and FIC, and was, according to Mr. Ross, "a bear on taking a look at the intercompany transactions of these two companies and a bear in attacking to make sure that compliance was going to occur".

Shortly after his arrival in the office, Mr. Smith received a memo written on June 10, 1986, by the lawyer whose advice Mr. Jewitt had sought on April 30 about means of dealing effectively with AIC and FIC. The lawyer outlined the statutory power to require the companies to provide information and to inspect documents, which she was confident would include "access to property appraisals, books of account and lists of assets". She also referred to the Superintendent's power to procure property appraisals but "apparently and unfortunately at his own expense", not at the expense of the registrant. There is nothing in the *Investment Contract Act* relating to

who should bear the cost of such appraisals, and as noted earlier, Mr. Smallacombe in 1972 had forced AIC to pay for a third appraisal.

Deficiencies Apparent in 1985 Annual Statements

Having volunteered to take over the AIC and FIC files from the filings analyst who had the companies' annual financial statements for the 1985 fiscal year, Mr. Smith reviewed the statements and, on June 12, 1986, sent memos to Mr. Edgar with regard to each company. In these memos, Mr. Smith identified a deficit in qualified assets of $43,338,530 for FIC and of $12,163,025 for AIC. He identified stocks and mortgages that he considered to have been overvalued by the companies' auditors, and he questioned whether some of the stocks were qualified assets. He recommended that an outside second opinion be sought, and posed the question: "Do we renew and follow with a suspension, or do we refuse to renew pending a hearing and review?" That was the dilemma the office faced, according to Mr. Smith, who also told us that

> you have to be prepared to get up at a hearing and provide the evidence that you acted correctly. You just can't stop somebody from selling without good evidence. That's the problem.

Mr. Smith concluded his memos by recommending either substantial amendment to or repeal of the *Investment Contract Act*.

On June 13, 1986, Mr. Smith met with Mr. Edgar, Mr. Affleck, and the Legal Services Branch lawyer who had written the June 10 memo, to discuss the companies' financial condition and the proper approach to be taken regarding their registration under such circumstances. Mr. Smith saw the options as being either to register the companies and then suspend their registrations and hold a hearing, or to "just cut them off". He considered neither option to be viable. He told us his approach would have been to put the companies on notice that they appeared to be in trouble, and then tell them that unless they agreed to a review of their records by an outside firm of chartered accountants, they would be suspended.

Mr. Edgar told us that he considered an outside review to be premature at that stage. He said he felt that it was important for Alberta, as the regulator of the primary jurisdiction, to take the lead and that it would not have been appropriate for B.C. to take regulatory action "unless Alberta simply kept saying nothing".

Mr. Edgar said that it would have been too early to put a notice in the *Weekly Summary* as it would have brought the companies down. If a member of the public had called to inquire about the companies, Mr. Edgar said, he would not have revealed the financial information held by the office because "it's not necessary for public consumption. We are not financial advisers." However, the Act did not require AIC or FIC to provide financial information to investors. The 1969 report of the Canadian Committee on Mutual Funds and Investment Contracts had emphasized that, because of the risks inherent in the investment contract business, it was of the utmost

importance that holders of investment contracts be entitled to receive regular reports concerning the financial condition of issuing companies.

Mr. Smith said Mr. Edgar suggested asking the companies to stop selling voluntarily, but Mr. Smith told us that to do so would be like "asking somebody to commit suicide". After the meeting, Mr. Edgar called Bill Johnson, Vice President—Finance of PGL, suggesting that the companies consider stopping their sales until the matter of their registration was settled. He told us:

> ... as I advised Johnson, I thought there was a great legal question over whether or not they had any viable contracts in the circumstances of their companies and that they should be concerned about that and that was the primary motive for suggesting that they not sell, that they do themselves the favour of avoiding that uncertainty. I must tell you it wasn't so much to protect investors.

Mr. Edgar also suggested that by appealing to the companies' self-interest he believed he would have more leverage in getting them to stop selling.

Request to Voluntarily Halt Selling

On June 16, Mr. Smith met with Mr. Marlin, the president of AIC and FIC, and Mr. Johnson, and hand-delivered a letter asking that AIC and FIC discontinue selling investment contracts voluntarily "until the problems, perceived or real, are satisfactorily resolved". He told us he was left with the impression that Mr. Marlin and Mr. Johnson did not intend to comply with his request. He thought it "more than likely" that he reported that fact to Mr. Edgar.

Mr. Smith requested from Mr. Marlin and Mr. Johnson detailed financial information with respect to the companies' assets that concerned him. He was particularly concerned about investments in three affiliated companies— Athabasca Holdings Ltd., Principal Neo-Tech Inc., and Matrix Investments Ltd.—which he suspected were not arm's length investments, and for which he therefore questioned the recorded values. He also questioned the values placed on mortgages and foreclosed properties and therefore requested values based on recent, independent appraisals. This information was provided within a few days of the June 16 meeting although Mr. Smith considered the information with respect to the mortgage portfolio to be inadequate. Included was a legal opinion obtained by the companies stating that investments in Athabasca Holdings, an affiliated company, were qualified assets under the *Investment Contract Act*. Mr. Smith accepted this legal opinion, and as a result reduced the amount of the deficiency he had originally estimated.

Mr. Smith worked evenings and weekends between June 24 and July 2 conducting an intensive review of the information he had been given. He made several calls to Principal Group officials to gather further details about inter-company transactions and investments of AIC and FIC affiliates, and to attempt to obtain information about the financial health of the group of companies as a whole. Mr. Johnson informed him of the deficiencies in

AIC's and FIC's assets identified by the Alberta Superintendent of Insurance's auditor. Mr. Smith called Mr. Saleh, the Alberta Superintendent of Insurance, who assured him that he would be advised of any change in the valuation of the assets of AIC and FIC by the Alberta regulators. Mr. Smith did not seek a legal opinion with respect to whether or not the companies' assets met the requirements of the *Investment Contract Act*. Nor did he, at this time, review the companies' quarterly statements for the period ending March 31, 1986, which had been received on June 20 and indicated further losses.

Based on available information, Mr. Smith's review was the first detailed review by the office of the holdings and financial condition of the companies since Mr. Smallacombe's review in 1972.

Demand for Capital Injection

On July 2, 1986, Mr. Smith provided his analysis to Mr. Ross, who had assumed his position as Superintendent a week earlier. Mr. Smith told Mr. Ross that he was concerned as to whether AIC and FIC had sufficient qualified assets to meet their liabilities. His analysis led him to identify a total shortfall of approximately $11 million for both companies, which was substantially less than the approximately $55 million total deficit in qualified assets that he identified in his preliminary analysis on June 12. "What becomes apparent," he noted, "is that the Group is cash poor and will remain so for some time". Mr. Smith concluded his report with six recommendations, including the recommendation that the problem of the deficiency of qualified assets be resolved "to our satisfaction" before July 31, 1986.

Accompanying Mr. Smith's memorandum was a letter, for Mr. Ross's signature, to Mr. Marlin, the president of AIC and FIC. The letter stated, in part:

> Before we will issue registration, we will require the following:
> 1. Insertion of qualified assets into AIC of $1,683,000 and FIC of $9,567,649.
> 2. Financial statements of Principal Group Ltd. as at December 31, 1984 and 1985.
> 3. Monthly financial statements for AIC and FIC for the months of April, May and, when available, June.
> 4. Complete detail of all significant related party transactions, including any two-step related party transactions.
> 5. The quarterly financial statement of Athabasca Holdings Ltd. and Principal Group Ltd. as at March 31, 1986 and, when available, June 30, 1986.
>
> We expect the qualified assets to be inserted and the unaudited financial statements to be in our possession by July 31, 1986 at the latest.

The letter was signed by Mr. Ross and mailed on July 4. Mr. Smith then went on vacation until July 23.

Mr. Ross told us that he did not read Mr. Smith's July 2 memorandum until later in the month because of pressing concerns elsewhere. Mr. Ross was aware that the companies "did not appear to be viable", but said he did not have the luxury or ability to conduct further research into the back-

ground to the companies' present condition. All the staff could do at that time was "cope and organize," he said.

However, shortly after receiving Mr. Smith's memorandum of July 2, Mr. Ross decided to permit the companies to continue selling investment contracts because he didn't "have enough information to shut them down". He told us he was unaware that Mr. Smith and Mr. Edgar had already asked them to stop selling investment contracts. He acknowledged that there was a "good argument" that the selling of contracts by an unregistered company was a breach of the *Investment Contract Act*. Mr. Ross said he was unaware of the monitoring of AIC and FIC by the Investigations Department in 1984 and 1985 and the information it had received about capital injections demanded by the Alberta regulators.

On returning from his vacation on July 23, 1986, Mr. Smith reviewed the quarterly financial statements for the period ending March 31, 1986, and identified additional operating losses of $2,032,860 for AIC and of $5,886,655 for FIC. He reported this by a memorandum to Mr. Ross the same day. No demand was made to the companies for a further infusion of qualified assets to reflect these further losses. Mr. Smith said such a demand would have been premature until the companies' profit and loss picture for the whole year was known. His previously stated concerns about the companies' failure to comply with the provisions of the Act had been based on his review of the December 31, 1985, annual financial statements.

Mr. Ross received and read Mr. Smith's July 23 memorandum, but his evidence varied with respect to his knowledge of the additional losses. He testified that he was unaware that the infusion of qualified assets requested in his letter of July 4 did not include the operating losses for the first quarter of 1986. This would have been unlikely, as Mr. Smith had just identified those losses after his review of the March 31, 1986, quarterly statements prior to his July 23 memorandum to Mr. Ross. He also indicated that he did not consider it appropriate at that time to request an additional infusion of qualified assets. He was of the view that the approximate figure of $11 million did not indicate the actual amount needed with any precision and before requesting additional capital he wanted a more searching investigation. He also indicated that he thought that the $11 million infusion was "sufficient at the time", which was the time of the demand in his July 4, 1986, letter.

In his July 23 memorandum, Mr. Smith wrote that he had talked to the Alberta Superintendent of Insurance's auditor, Mr. Eldridge, who told him that Alberta had seen interim statements for the first five months of the year that showed AIC to be breaking even as a result of a non-arm's-length transaction, but FIC to be losing $8.5 million for that period. Mr. Smith reported that Mr. Eldridge had told him that Mr. Saleh "was doing something but would give me no clear indication as to what that something was".

Mr. Smith concluded his memo with the statement: "Clearly, we cannot allow AIC and FIC to do business without registration with the full knowledge of this deterioration in their asset base." He suggested that Mr. Ross

set up a meeting before July 31 with Mr. Saleh (the Alberta Superintendent of Insurance), Mr. Marlin (the president of AIC and FIC) and Donald Cormie to work out a satisfactory solution or suspend registration. Mr. Ross told us he decided not to accept the suggestion, as the regulatory authority in Alberta had shifted from the Office of the Superintendent of Insurance to the Alberta Treasury Department. Mr. Ross knew Allister McPherson, a Deputy Provincial Treasurer, and thought he could deal with him effectively over the phone.

Mr. Ross said that he viewed the Alberta regulators as being "principally responsible". Concerned that B.C. had less than adequate information on AIC and FIC, he talked to Mr. McPherson in July about hiring a consultant to do an independent review. Mr. Ross recalled that Mr. McPherson suggested B.C. hire the consultant, but Mr. Ross declined to do so because "if Allister is dealing with it, he is looking for a consultant who is on the spot".

On July 31, the deadline set in Mr. Ross's letter of July 4, Mr. Johnson hand-delivered to Mr. Smith a letter from Mr. Marlin to Mr. Ross. The letter questioned the methods used to calculate the companies' qualified assets. It argued that errors in Mr. Smith's valuation, combined with new information on the value of real estate holdings as well as forthcoming replacement of certain shares held by AIC with cash indicated that there would be no deficiency in qualified assets. .

Mr. Marlin further noted that PGL was not prepared to release its financial statements to the Superintendent of Brokers but that Mr. Smith or Mr. Ross were welcome to review those statements in Mr. Johnson's presence. During the meeting, Mr. Smith refused to look at the statements because Mr. Johnson would not allow him to photocopy them or give him a reasonable length of time in which to review them. In Mr. Affleck's recollection, the importance of seeing the statements was that "it's got to be something more than promises. It's got to be assets that are credible."

Mr. Smith said he "tended to ignore the substance of Marlin's [July 30, 1986] letter" as "it was evident that all this is is a delay tactic". On August 1, he wrote to Mr. Ross, reporting on the meeting and saying that he could see little point in discussing Mr. Marlin's letter as "the technical accuracy of some of these potential registrants' holdings has little to do with the more important question relating to the substance of the holdings". In a memorandum to Mr. Ross, Mr. Smith stated:

> The continued non-arm's length transactions to generate book profits [do] not instil any confidence in me. I would not personally invest $1 in either company and I can see no reason why any other resident of this province would do so if he had possession of the financial information known to us.
>
> I therefore continue to recommend that registration not be issued and that both companies be stopped from selling investment contracts or rolling over existing investment contracts. As you are aware, they are presently selling without registration, which is illegal, and registration should be granted or refused. Continued operation in the twilight zone cannot be encouraged.

Notwithstanding Mr. Smith's recommendations, Mr. Ross decided to give the companies more time, as they claimed to be intending to provide further qualified assets. He told us that until he was satisfied that the companies could not be retrieved, he was not going to initiate "a mischievous act of putting them out of business". He said he had presumed at the time that the *Investment Contract Act* gave him the discretion to allow the companies to continue to sell while unregistered, although he later recognized that this was not so.

This decision was made four months after the companies' registrations had expired and a month and a half after Mr. Edgar and Mr. Smith had requested that the companies stop selling.

On August 14, Mr. Smith again spoke to officials of the Principal Group on the subject of voluntarily stopping selling, and he told them the office's position hadn't changed since Mr. Ross's letter of July 4. In an August 14 memorandum to Mr. Ross, he described the position he had presented to the officials: any alteration in land valuations by the companies would require confirmation by the Alberta government; if the $11 million "cash" [Mr. Smith told us he meant assets] injection to compensate for present property values was subsequently determined to be unnecessary, it could be reversed; mutual fund units would be considered acceptable as marketable securities; AIC's sale of Matrix shares to Athabasca Holdings Ltd. was not acceptable; and financial statements of Athabasca Holdings and PGL had to be submitted to the Superintendent of Brokers' office. About this time, Mr. Ross had approved mutual fund holdings as acceptable qualified assets, according to Mr. Smith.

Mr. Smith told us that in mid August, at a meeting with Mr. Edgar, Mr. Ross and Ms. Bodkin, the chairman of the yet to be proclaimed Securities Commission (to whom the Superintendent of Brokers would report after February 2, 1987), he was instructed to again ask the companies to stop selling, as they had not complied with the demand to insert assets by the deadline of July 31. Mr. Smith told us that he thought that by this time the companies had had an opportunity to respond, and that a hearing would have been appropriate; it was now two months since his meeting with Mr. Johnson at which he had hand-delivered a letter asking the companies to stop selling investment contracts. However, he said, "everybody seems to want to have the cash in and to get them registered rather than to go to a hearing..."

Injection of Assets and Registration of AIC and FIC

On August 27, Mr. Marlin presented to Mr. Smith a letter which claimed that PGL had injected $1,683,000 into AIC and $9,567,649 into FIC by way of promissory notes secured by PGL's interest in certain mutual fund holdings. In return AIC and FIC had issued subordinated notes payable to PGL for the same amounts. All the notes (secured promissory notes and subordinated notes) contained a provision that they could be "prepaid in whole or in part at any time without notice or bonus". PGL's interest in the subordinated notes payable to it was stated to be subordinated to the interests of

"general creditors", which were defined to include investment contract holders.

Mr. Smith told us that he "took at face value the fact that [PGL] had inserted qualified assets" into AIC and FIC. "I am not an outside auditor here, I'm just a regulator," he said. "I don't examine all of their assets in detail." When asked if he was aware of PGL's financial position, Mr. Smith told us:

> I [was] prepared to suspend. Now, they produce something they call qualified assets. Somewhere along the line I would receive instructions to take them and I do. . .that's the end of it.

Following his meeting with Mr. Marlin, Mr. Smith sent a memorandum to Mr. Ross, attaching Mr. Marlin's letter and copies of the notes and collateral agreements. He told Mr. Ross that in view of the injection of qualified assets he no longer objected to the registration of the companies.

Mr. Smith told us that he had not examined how cash could be realized from the collaterally secured mutual funds. He said he had not determined what mutual funds they were, what PGL's interest in them was, or what amount was unencumbered by prior charges. Whether the secured promissory notes issued by PGL were qualified assets depended on a review of PGL's financial history, and specifically of payment of dividends over time, which was required to meet the requirements of the *Trustee Act* or the *Canadian and British Insurance Companies Act*. Neither Mr. Smith nor anyone else in the Superintendent's office reviewed PGL's financial statements with this in mind.

In 1974, Mr. Irwin and Mr. Smith had refused to permit FIC to issue subordinated promissory notes payable to PGL which contained a provision that PGL could be repaid at any time, in the absence of a clause requiring the consent of the Superintendent to any payment on the subordinated notes. The companies were forced to comply with the demand before their registration was issued. Mr. Smith explained that in 1986 he felt that the investment contract holders were "better off than they [had been]" as a result of the capital injection, and he was relieved that the companies had come through to the extent they had, because "I really [didn't] know and still don't know whether anybody would have ever held a hearing or when they would have ever stopped selling".

Mr. Edgar told us he didn't know whether it might have been possible to hold a hearing in the summer of 1986. While such a step might not have been problematical in the case of a securities company, he said, it could have serious effects for a financial institution because "the mere fact that it's being investigated and is the subject of a hearing could be enough to cause a run".

During our investigation, Mr. Smith was asked whether his position on AIC and FIC was affected by his discovery of an $8 million loss in the companies' financial statements for the first quarter of 1986. His response is significant, in light of his subsequent acquiescence in his dealings with AIC and FIC:

> I reported on June 12th a situation I don't like, I reported on June 23rd a position I don't like, I reported on August 14th a situation I don't like. Now what makes you think if I raised the ante to $15 million we're going to suspend registration or, in fact, do anything? . . . I'm not getting anywhere in my recommendations, and it becomes quite evident to me that British Columbia as a province is not going to act unilaterally.

Mr. Ross told us that he noticed that the promissory notes issued by PGL and payable to AIC and FIC were secured by PGL's interest in mutual funds, but assumed Mr. Smith had reviewed the notes to see whether they were qualified assets. He said he was not aware that the subordinated notes issued by AIC and FIC and payable to PGL contained no provision requiring permission of the Superintendent prior to their repayment. Had he known of that fact, he said, he would not have accepted the promissory notes as qualified assets. On the one hand, he agreed that it was necessary to see PGL's financial statements to determine whether the parent company had sufficient assets to provide collateral for the secured promissory notes, but on the other hand he said there was no need to look at them as long as assets became available.

The day after receipt of Mr. Marlin's letter, on August 28, 1986, registration was issued for AIC and FIC and backdated to April 1, 1986. Data provided to this office from the Alberta court-appointed managers of AIC and FIC indicate that 1,500 investment contracts totalling $12 million or more were sold in B.C. during this five-month unregistered period.

Legal Opinion on Regulatory Powers

Three days before AIC and FIC were registered, the Legal Services Branch sent a memorandum to Mr. Ross with respect to the regulation of AIC and FIC. However, it was apparently not received until "it was too late", Mr. Smith told us, because by that time the decision had been made to accept the promissory notes as qualified assets and the companies had been registered.

The legal opinion stated that the issuing or offering for sale of investment contracts by companies that were not registered was an offence under section 26 of the *Investment Contract Act*. It followed, it said, that failure to enforce the provisions of the Act in such circumstances could result in an action in negligence against the Office of the Superintendent of Brokers. Referring to the fact that the office had made a decision not to register the companies until their problems were resolved and that it had taken no action to enforce the provisions of the Act or issue a public notice of the companies' illegal selling, it recommended that if the companies did not immediately cease selling or resolve their problems, the Superintendent issue a public notice and refer the matter to Crown counsel for prosecution.

On September 4, Mr. Ross wrote to advise the Legal Services lawyer that the companies had complied with his request for additional assets and had been registered. He added that future violations would be dealt with with "less patience".

Review by Alberta Regulators of Promissory Notes Exchange

On September 9, 1986, an auditor for the Alberta government wrote a memorandum analyzing the approximately $11 million exchange of notes between PGL and its subsidiary companies. She expressed particular concern about the nature of the non-arm's-length transactions, a note in the agreements between the companies that the market decline in qualified assets was viewed as temporary, and the failure to provide a guarantee that the subordinated notes would not be repaid by AIC and FIC to PGL without the consent of the Superintendent of Insurance.

The auditor's concern led to a meeting among senior Alberta regulators in which the decision was made to request Mr. Marlin to provide a legal opinion and an auditor's opinion with regard to the nature and amount of the qualified assets alleged to be injected into the companies as a result of the arrangement. Notes taken at the meeting indicated that the regulators considered the effect of the exchange of the promissory notes to be "negligible". An unsuccessful attempt was made at the meeting to contact B.C. regulators to find out why they had accepted the notes.

Minutes of a follow-up meeting the next week indicated that the regulators had contacted an unnamed source in B.C. and were aware that B.C. had found the companies' action acceptable. However, it is apparent that Alberta did not fully inform the B.C. regulators of their own concerns. Mr. Smith told us he had not seen the Alberta auditor's memorandum. The result of the lack of communication and coordination of the two provinces' approach in their dealings with AIC and FIC was that one province accepted the promissory notes as qualified assets while the other had serious doubts about their substance.

Monitoring of AIC and FIC After Registration

Mr. Ross told us that he considered Mr. Smith to be responsible for regulating AIC and FIC after their registration, even though Mr. Smith, having left the office to resume his position as a policy analyst with the Ministry of Consumer and Corporate Affairs, on July 31, 1986, was only assisting Mr. Ross in an informal manner. However, Mr. Smith told us it was his understanding that his involvement with the companies came to an end in the latter part of September, by which point his work with the office was primarily related to the new securities legislation. He assumed that Mr. Ross was monitoring the companies after that point and said he gave Mr. Ross all his working material on AIC and FIC in a three-ring binder in September.

Review of September 1986 Quarterly Financial Statements

The unaudited financial statements for the quarter ending September 30, 1986, arrived on October 30 and were sent to Mr. Smith. He told us he assumed the statements had arrived on his desk by accident, but quickly reviewed them anyway and told Mr. Ross the results were poor, indicating further losses of $6,526,000 for FIC and $447,000 for AIC for the first nine months of 1986. Mr. Smith continued:

> We did not receive any of the further information which would enable us to consider favourably their continued registration. We did not receive the financial statements of Athabasca Holdings Ltd. We have no information of the holdings in "securities" of the inter-related companies such as Matrix. All in all these registrants are going to give continual problems and quite frankly a withdrawal of their registration must once again be considered. I recommend that you contact the Superintendent of Insurance, Alberta or Treasury Board with the view to jointly demand immediately, a further cash infusion in the amount of the combined unaudited losses for the 9 months; which is First $(6,526) Associated $(447), combined loss $(6,973). I am returning the files by overnight inter-branch mail but consider this matter to be most urgent and therefore am faxing this letter to you immediately. Bill. [figures are in thousands]

Mr. Ross told us he did not consider holding a hearing on receiving this information, as

> we still didn't know in the long run whether the companies were viable or not and if I had [cancelled the registration] it would again be tantamount to putting them out of business... I thought that would be mischievous and irresponsible.

Instead, Mr. Ross told us, he telephoned Mr. McPherson, a Deputy Provincial Treasurer, after he had reviewed Mr. Smith's memorandum and again asked him to appoint an independent consultant. He told him that if Alberta chose not to do so, B.C. would. Mr. Ross said that Mr. McPherson agreed to do so and told him a complete review would be done. After the consultant was appointed, Mr. Ross was told his report was due to be delivered in January 1987. Mr. Ross told us he did not meet with company officials in January because "by that time everything was taken out of their hands" as the consultant's review had begun.

Involvement of Securities Commission Chairman

The Chairman of the B.C. Securities Commission told us that had she known in the autumn of 1986 how serious the situation was with the Principal Group,

> I would by that time, I'm quite sure, have been insisting either that we were involved with Alberta in establishing the terms and conditions and the reports that we were going to get from the monitoring that Alberta was doing or we would have been hiring independent consultants...

Ms. Bodkin told us that in November 1986 she met Donald Cormie in Vancouver, reminded him of B.C.'s concerns about his companies' practices, and suggested he go and see Michael Ross. There is no indication that he did so or that Ms. Bodkin passed the information on to Mr. Ross. Mr. Ross stated that he was not visited by Mr. Cormie and that he was unaware of Ms. Bodkin's suggestion.

Review of 1986 Draft Annual Financial Statements

On January 20, 1987, Mr. Johnson of PGL wrote a memorandum to file indicating that he had talked to Mr. Ross, suggesting that he meet with Mr. Marlin and him to discuss the 1986 unaudited annual financial statements for both companies, which were received by the Office of the Superintendent of Brokers that day. Mr. Johnson noted that Mr. Ross had said such a meeting was unnecessary as he had had numerous conversations with the Alberta regulators, who were the primary regulators and were reviewing the situation. He reported Mr. Ross as saying that from now on the financial statements were to be all "real" and not "numbers". Mr. Ross told us that he did not at this point ask for another injection of qualified assets because he was waiting to find out the amount of the deficiency identified by the consultant who had been hired by Alberta.

Draft 1986 unaudited annual financial statements for both companies were sent at the end of January 1987 to Mr. Smith, who told us he thought he had received them as a result of an error on the part of the file room. Consequently Mr. Smith sent them back, unreviewed, to the new Director of Registration, with a note saying that "some person on your staff still insists that I am the person to receive files relating to investment contracts".

When Mr. Ross resigned effective February 2, 1987, he did not brief his successor, Mr. Sinclair, on his efforts to obtain information from Alberta about the affairs of AIC and FIC. Although Mr. Ross told us he briefed Deputy Superintendent Mulligan about certain matters, the latter told us he did not recall anything about AIC and FIC and was unaware until later that there was any risk that the companies might not be financially viable.

Chapter X

The Regulation of AIC and FIC, February to July 1987

On February 11, 1987, David Sinclair, a senior chartered accountant and managing partner of a major Vancouver firm, was appointed Acting Superintendent of Brokers to replace Michael Ross, who resigned on February 2. One of his primary tasks was to find a suitable individual to fill his position on a permanent basis. That individual was Neil de Gelder, who became Superintendent of Brokers on June 1 and who cancelled the licences of AIC and FIC a month later.

1. Registrations and Filings

The draft 1986 annual financial statements for AIC and FIC were received by the Registration Department on January 20, 1987. They were forwarded to Bill Smith, who had left his post as Acting Deputy Superintendent on July 31, 1986, to resume his previous position as a policy analyst with the Ministry of Finance and Corporate Relations. On February 3 Mr. Smith sent them back to Vancouver to the new Director of Registration. In an accompanying memo, Mr. Smith stated, "Some person on your staff still insists that I am the person to receive files relating to investment contracts." He told the new Director that both companies were in financial trouble and that the independent consultant's report that had been commissioned by the Alberta Superintendent of Insurance was due to be submitted any day.

The applications for renewal of registration submitted by AIC and FIC for 1987-88 were dated February 24, 1987. FIC's application was stamped "received" on February 26, AIC's on April 6.

On March 18, 1987, the registration clerk approved FIC's application for renewal and issued the certificate the following day. Mr. Sinclair told us he was not consulted about the decision to renew FIC's registration.

AIC's certificate was issued on April 7, the day after the company's application was marked "received". The company at this point had submitted only draft annual statements for 1986. Mr. Sinclair told us he approved the renewal of AIC's registration because to do otherwise would bring about the company's collapse, and "one simply had to have time for a full assessment and time to find out if there was anything that could be done to salvage or mitigate the situation". As described below, B.C. was now urging and expecting imminent action to be taken by the Alberta regulators to ensure an immediate injection of equity into AIC and FIC.

2. Financial Regulation

When he learned of Mr. Sinclair's appointment as Acting Superintendent, Bill Smith contacted him immediately to alert him about the serious financial condition of AIC and FIC, which he knew had not addressed the $7 million losses that he had described to Mr. Ross in November 1986. Mr. Sinclair asked Mr. Dilworth, the Director of Investigations, to ascertain the current financial status of the companies.

On February 26, Mr. Dilworth told Mr. Sinclair that he had called the Alberta regulators and had been told that "they had a good handle on the matter" and had told him, "Don't worry until we do something". He also said that his chief investigator had been told by the Alberta regulators that the independent consultant's draft report had been received and that it was to be discussed with company officials on March 3. Mr. Sinclair followed up by calling a senior Alberta regulator and was told the report was not yet complete. He finally received a copy on March 16, but was advised a few days later that the report was still not in its final form as the consultant's assessment was not completed.

The Report on AIC and FIC

The conclusions reached by the independent consultant in its draft report were devastating. The chartered accountant firm made a significant downwards adjustment in the values of the assets of AIC and FIC, indicating that the values identified in the companies' audited financial statements were not supported by available information. Moreover, the consultant concluded that the normal return on the companies' investments was insufficient to cover obligations to investment contract holders. Because of these findings, the report recommended that the Alberta Superintendent of Insurance cancel or suspend the licences of AIC and FIC and appoint a receiver or liquidator.

Mr. Sinclair told us that the draft report made it clear to him that a full-scale assessment was required. He believed that any action taken by B.C. should be done in concert with the Alberta regulators, but said that if Alberta, as the primary jurisdiction, was unwilling to act, B.C. was pre-

pared to do so unilaterally. He asked a lawyer in the Legal Services Branch to draft suspension orders for him in case they were needed on short notice, and these were provided on March 23—four days after FIC's renewal certificate had been issued by the Registration Department.

The lawyer attached to the draft suspension orders a memo advising Mr. Sinclair that the Act made no provision for a short-term renewal of registration. Any renewal would be valid until March 31, 1988, although "assuming there are grounds, it can be suspended or cancelled at any sooner time".

Request for Alberta Action

On the same day, March 23, Mr. Sinclair wrote to Mr. Kalke, an Alberta Deputy Provincial Treasurer, saying that if no arrangement was made to provide for a substantial injection of new equity into the companies, he considered suspension of their registration to be imperative. He indicated that B.C. was looking to Alberta, as the primary jurisdiction, to take the lead in developing a course of action. In the meantime, he stated, B.C. had no choice but to renew the companies' registrations, as withholding approval would undoubtedly precipitate a collapse.

Mr. Sinclair told us that it would have been irresponsible to force the collapse of the companies while there remained a possibility of their financial position being strengthened. He recognized that cancellation of their registration would protect the interests of investors who had not yet signed contracts with the companies, if the companies' demise was inevitable. On the other hand he knew that cancellation would create immediate losses for all the investors currently holding contracts—losses that might still be avoidable if an injection of sufficient equity occurred promptly.

On the same day that he wrote to Mr. Kalke, Mr. Sinclair wrote to the Minister of Finance and Corporate Relations, the Hon. Mel Couvelier, to inform him of the gravity of the situation and to alert him to the magnitude of investor losses that would occur if the companies were to collapse.

On April 6, Mr. Sinclair wrote again to Mr. Kalke to express his concern that firm action be quickly taken. A meeting was set up for April 27, to be attended by the Alberta regulators, the independent consultant and Mr. Sinclair, Mr. Smith and the Director of Registration from B.C. At the meeting, the consultant indicated that the completion of its report was being delayed pending receipt of audited financial statements from AIC and FIC. By this time it was becoming apparent to Mr. Sinclair that B.C. might have to take unilateral action, and he engaged the services of a retired senior banking official to help him prepare for that eventuality.

PGL Commitment to Prepare Business Plan

On May 7, regulators from both provinces met in Edmonton with representatives from both the independent consultant and the Principal Group. The result was that the Principal Group representatives agreed to prepare a proper business plan for the entire Principal Group of Companies within the next three weeks and to deliver a progress report to Treasury Depart-

ment staff every four days. Mr. Sinclair asked for complete financial statements, whether audited or not, for all of the companies, so that B.C. could attempt to evaluate the financial condition of the Group as a whole as expeditiously as possible. Most of the requested information was provided the following day.

On May 21, Al Mulholland, the B.C. Superintendent of Financial Institutions, prepared a memo for Mr. Couvelier on the financial stability of AIC, FIC and PS&T, recommending a detailed analysis of the assets of the Principal Group and recommending against a bailout of the companies by the province. The retired banking official recast the balance sheets for AIC and FIC and provided a copy to the Alberta regulators, who in turn gave him a copy of the revised consultant's report on May 25 and told him that the companies had agreed to issue no new investment contracts, although they would roll over existing ones until such time as the companies' capitalization could be improved or alternative corrective action taken.

In a memo to Mr. Sinclair dated June 4 but apparently written before June 1, the retired banking official noted that the companies had provided no evidence of any means of funding their deficit. It appeared to him, he said, that the Alberta Treasury Department was prepared to "let this matter drag on, hoping that improvement of equity will come from sale of assets or raising of new capital". He suggested that if a target date of July 1 were set for improvement of the companies' equity by at least $130 million, it would "force the hand of Alberta Treasury to support or otherwise".

Request by PGL for Government Financial Assistance

On June 3, three meetings were held in Edmonton. In the first, between the B.C. and Alberta regulators, Mr. Sinclair indicated that B.C. considered the companies to be insolvent, would provide no financial support for a bailout plan, and was of the opinion that a receiver should be appointed at the first available opportunity.

In the second meeting among PGL officials and B.C. and Alberta regulators, PGL officials presented eight "salvage scenarios", of which their preferred one provided for an immediate repayment of all certificate holders with government funding of $385 million, which would be reduced to approximately $177 million after liquidation of the companies' assets. The "executive summary" to the plan stated: "It is apparent that these two companies can no longer be supported; but the remaining Principal Group of Companies ought to be preserved."

The third meeting, between the regulators of both provinces, discussed the issues raised by the meeting with the companies, including the manner in which AIC and FIC could be collapsed so as to maximize return to the investors. Mr. Sinclair indicated to the Alberta regulators that he thought a request for financial support would not be favourably received by the B.C. government because it was not B.C.'s practice to support failed financial institutions and because the matter was then seen to be primarily Alberta's responsibility.

The following day, June 4, Mr. Sinclair stated in a memo, to be used as a basis for discussion with the Minister, Deputy Minister and Assistant Deputy Minister of Finance, that Alberta had indicated it might consider indemnifying Alberta investors in the event of a collapse and suggested that any request by Alberta for B.C. participation in the financing of a support package for the companies be refused. While cooperation between the provinces in resolving the matter was desirable, he stated, B.C. might have little option other than to suspend the companies' registrations if Alberta allowed the situation to drift on more than a couple of weeks.

Also on June 4, the retired banking official advised Mr. Sinclair that FIC was continuing to accept new money from investors, with representations that it was guaranteed, in violation of the agreement made with the Alberta regulators a week earlier and despite a directive issued by Mr. Marlin to his employees on June 2.

On June 8, Mr. Sinclair met with the Minister, Deputy Minister and Assistant Deputy Minister, relating the information and opinions expressed in his June 4 memo. He then called Mr. Kalke to confirm that the B.C. government was not prepared to provide financial support to AIC and FIC and was ready to suspend the companies. Mr. Kalke told him that a memo had been prepared for delivery to the Alberta Treasury Minister the same day, and a quick response was anticipated. Mr. Sinclair updated Neil de Gelder, who had succeeded him as Superintendent on June 1, at which point Mr. Sinclair's involvement in the regulation of AIC and FIC was effectively concluded.

Mr. de Gelder told us he was under the impression that Mr. Sinclair had given Alberta an end-of-June deadline for action to be taken. He said that during the last two weeks of June, B.C. was simply waiting to see whether the deadline would be met and what Alberta's decision would be.

Collapse of AIC and FIC

On June 30, 1987, Kenneth Marlin, the President of AIC and FIC, filed an affidavit with the Alberta Court of Queen's Bench stating that "Associated Investors is insolvent and unable to pay all of its obligations as they fall due". A similar affidavit was filed for FIC, and an application was made for an order pursuant to the *Companies Creditors Arrangement Act*. When the order was granted the same day, June 30, the Alberta Treasury Department immediately cancelled the company registrations of both AIC and FIC.

On the following business day, July 2, Mr. de Gelder cancelled the licences of both companies in British Columbia.

Chapter XI

Financial Review

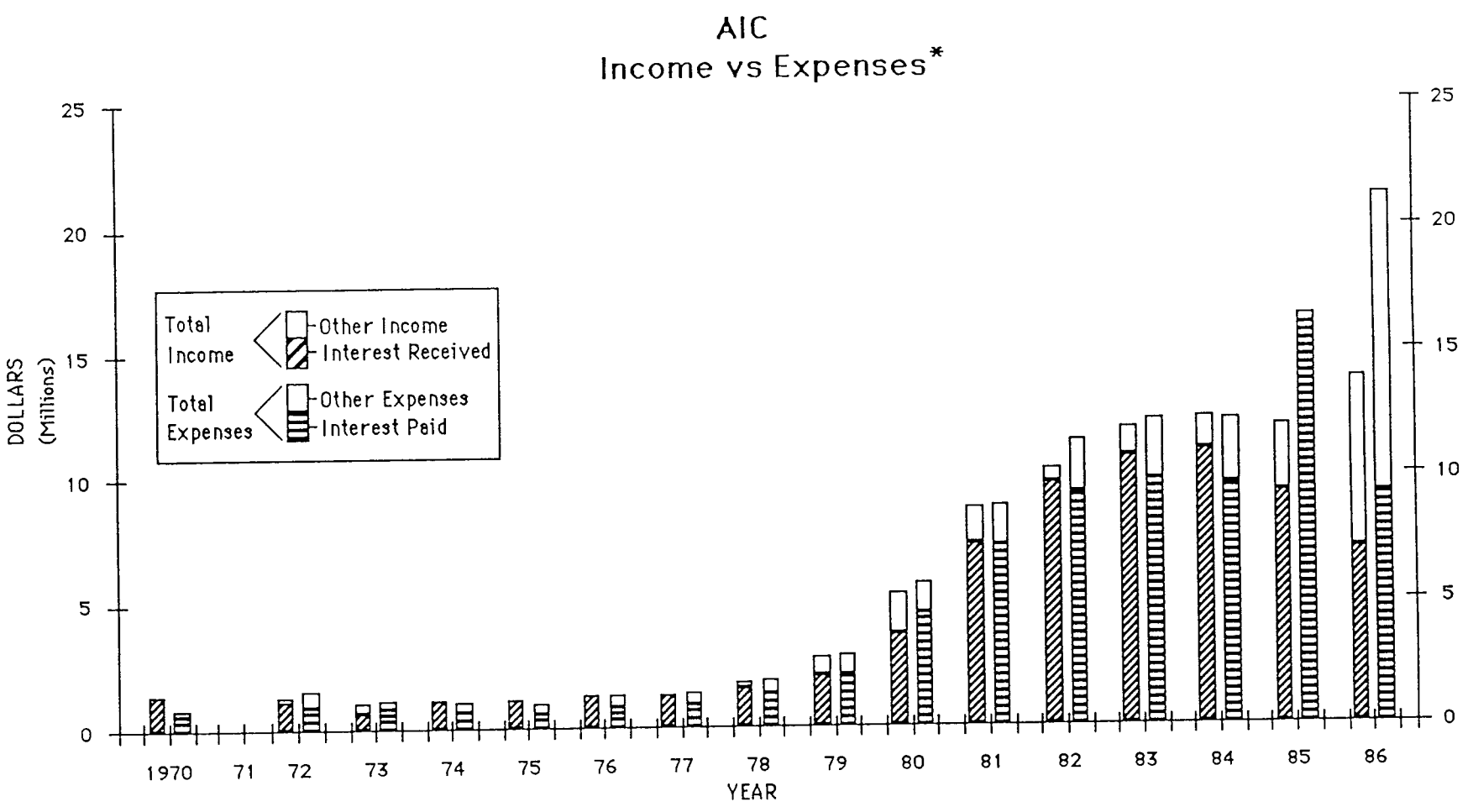
Introduction

A number of general comments may be helpful to the reader. This review was based largely on the companies' financial statements and accompanying auditors' notes: information easily obtainable by regulators and required to be filed under the *Investment Contract Act*. Only annual financial statements have been reviewed for the years 1970 to 1977 and 1986. For 1978 through 1985 both annual financial statements and the reports of the Alberta regulators were reviewed. The time required to perform a review of annual audited statements alone is estimated to be approximately two to three hours per year. The bar charts on the following pages indicate the nature of the information that could have been obtained from a cursory examination of the financial statements of AIC and FIC.

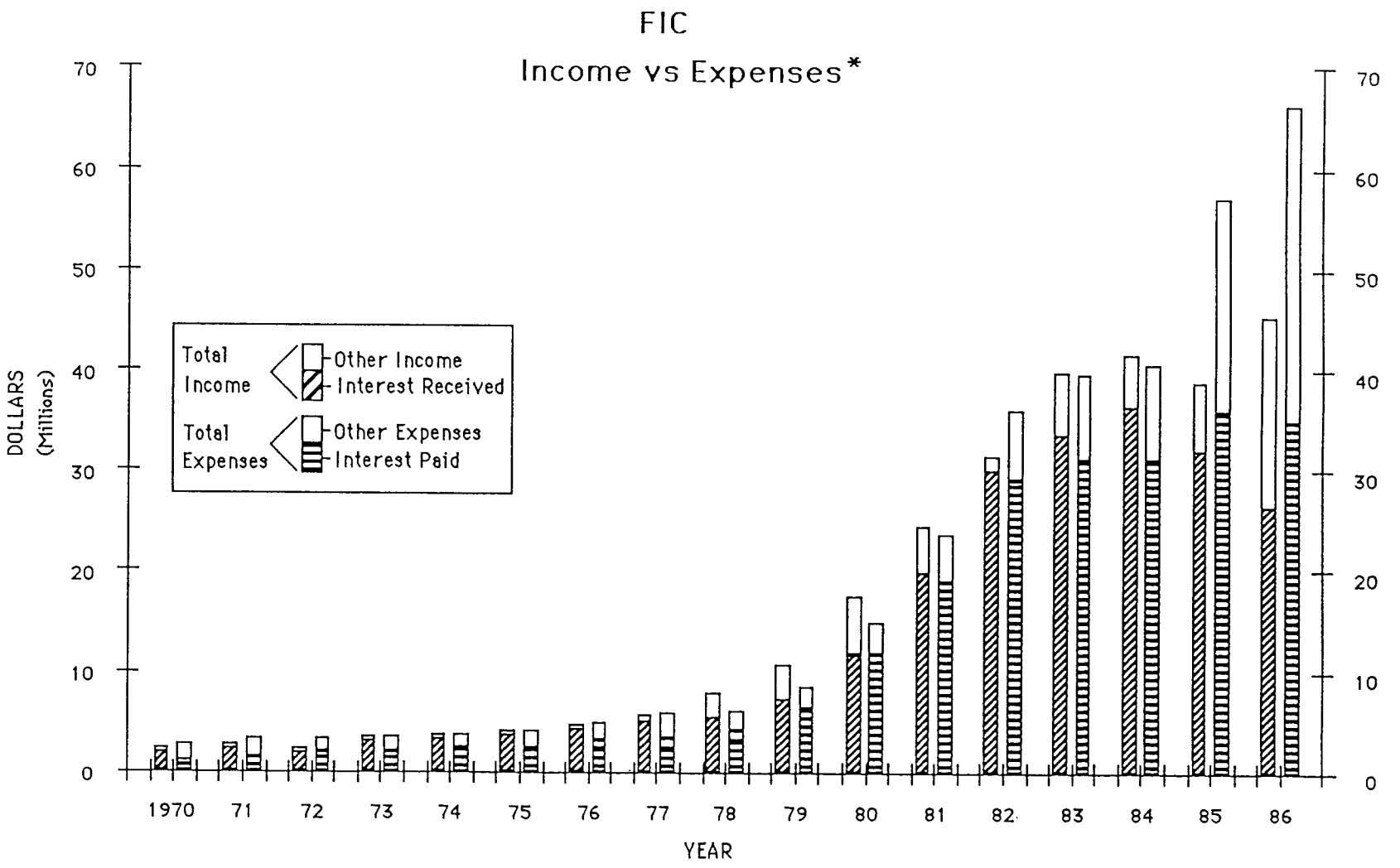
Based on the annual investigation information prepared by and obtained separately from the Superintendent of Insurance of Alberta, it was possible to obtain outside confirmation of our analysis of the companies' financial difficulties using only the annual audited financial statements. We should also state that we have taken a conservative approach in our analysis of this material.

Section 10 of the *Investment Contract Act* required that a registered issuer was to maintain "reserves" adequate to pay its outstanding investment contracts. Section 5 required that an issuer was always to have an unimpaired paid in capital plus surplus totalling at least $200,000.

The presentation and terms used in the annual financial statements differ from those of the quarterly filings required under the *Investment Contract Act*. As the annual statements do not include calculations of qualified asset and unimpaired capital requirements, it was not possible to determine precisely the amounts which would have been reported in the quarterly statements required under the Act. However, the B.C. regulators, even without



* Taken from company financial statements and accompanying notes.



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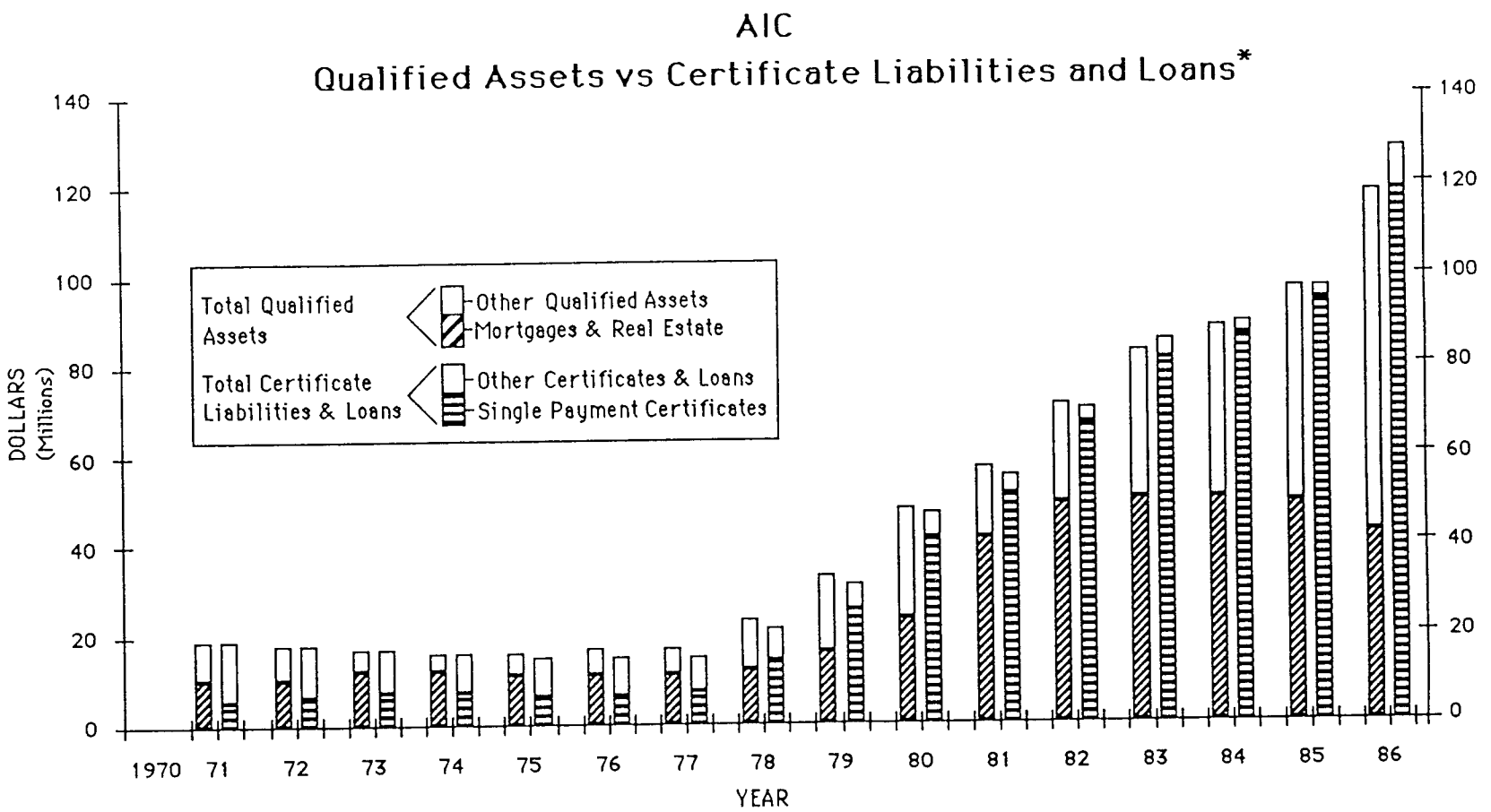
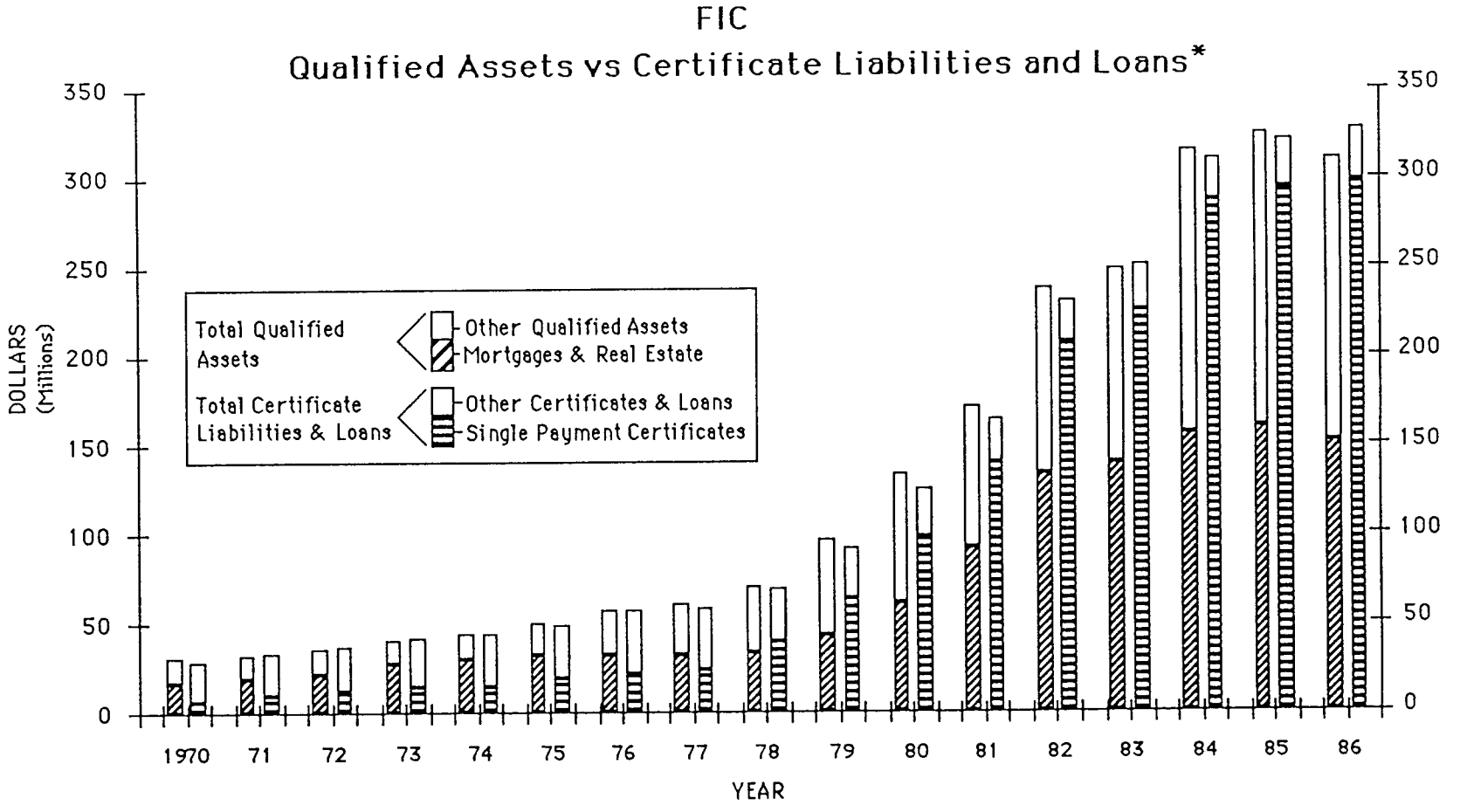


* Taken from company financial statements and accompanying notes.



* Taken from company financial statements and accompanying notes.

the required quarterly filings, could have used information available in the annual financial statements to prepare a simple analysis which would have provided them with an indication as to whether or not the registered issuer met the statutory tests.

As an estimate of "qualified assets" held in reserve, it is reasonable to use the amount reported as "investments" in the financial statements, with stocks reduced from cost to market values (as required under the *Investment Contract Act*). These figures can then be compared to the total of certificate liabilities and other liabilities such as bank loans, which could have priority over certificate liabilities. This comparison gives an estimate of whether the section 10 test is met; that is, are there sufficient reserves to meet certificate liabilities? Amounts owing to related companies were not deducted in order to show a conservative amount of any "reserve" shortfalls.

The term "unimpaired" is not defined in the Act. As an estimate of "unimpaired capital", it is reasonable to use the "total shareholders' equity" minus any deficiencies found in the amount of qualified assets needed to discharge liabilities.

It is important to note that the *Investment Contract Act* did not include specific references to income tests: that is, do income amounts exceed expenses (as they should if a company is to remain viable). Companies were, however, required to file annual audited financial statements (the annual year-end for AIC and FIC was December 31), which were to include income statements and which would therefore have been available for review by B.C. regulators.

We performed the tests described above, and the results follow.

1. 1970–1977

During the period from January 1, 1970, to December 31, 1977, the financial statements of FIC showed an excess of qualified assets over miscellaneous and certificate liabilities every year. The company, therefore, had the appearance of being able to pay off its debts to investors and creditors. However, if stocks are reduced from cost to market values (as required under the *Investment Contract Act*) and amounts overstated in the auditors' opinion are deducted, deficiencies result for the years 1971 to 1973. Items overstated in the auditors' opinion included dispositions of marketable securities at recorded costs rather than at fair market values (overstated in 1970 by $194,000), and recording future, unearned profits (overstated in 1972 by $480,500—removed in 1973).

During this period FIC's total shareholders' equity exceeded capital amounts required under the *Investment Contract(s) Acts* of B.C. ($200,000) and Alberta ($500,000). They therefore appeared to comply with the capital requirements of the Act.

When FIC's income statements are examined for the period from 1970 to 1977, it can be seen that the company's expenses exceeded its income every year except 1974. Although the income FIC received on investments was

greater than the interest it paid to investors and creditors, it was not sufficient to cover the operating expenses. After various questionable accounting adjustments, the resulting losses become net gains in 1970, 1971, 1974 and 1976. Nonetheless, it should have been obvious to any trained reviewer that FIC had expenses greater than the amount it was earning on its investments. One could then conclude that the shortfall would have to be met by infusions of capital from shareholders or by cash received from purchasers of investment contracts.

When a similar analysis of AIC's financial statements is performed (the 1970 balance sheet and 1971 income statement were not available to our reviewer), we found excess qualified assets every year, which therefore would have met *Investment Contract Act* criteria for qualified assets held in reserve. However, expenses exceeded income for the years 1972, 1973 and 1977. AIC was not registered in B.C. between April 1, 1973, and January 26, 1978.

Conclusions

It is not possible, as explained above, to determine the exact amounts of "qualified" assets and "unimpaired" capital needed to meet *Investment Contract Act* tests without more information. However, estimates of these amounts, calculated as discussed above, lead to the conclusion that although AIC probably met reserve tests, FIC probably did not meet the requirements of the *Investment Contract Act* for qualified assets held in reserve for 1971 to 1973. Finally, both companies encountered problems with expenses exceeding income throughout this period.

2. 1978–1983

Financial statements of the companies were reviewed for the years 1978 to 1983. The results of annual examinations by the Superintendent of Insurance of Alberta were also available and were reviewed.

The period from January 1, 1978, to December 31, 1983, was marked by substantial increases in investments and in contract liabilities for both AIC and FIC. The $70 million growth for AIC was four times the 1977 amounts for investments and contracts, and for FIC the $200 million increase was three to four times the 1977 amounts.

The increase in sales of contracts led to increased amounts for commission expenses and administration fees, which were not always covered by the difference between interest income received by the companies from their own investments, and the amount of interest the companies had to pay to investment contract holders. In fact, this "spread" decreased to almost nil for AIC in 1979 and for FIC in 1980. This may have been due to the fact that the companies had a significant proportion of their long-term investments earning fixed rates of interest which were lower than the more competitive rates they had to offer to their short-term investors. For the rest of this period, the companies paid out almost as much interest to investors as they reported as earned on their own investments. The need to also cover

operating expenses made the companies more reliant on attracting new investors in order to generate cash to pay interest to existing investors.

In view of the fact that it was the companies' policy to record interest revenue on mortgages in arrears (by "capitalizing" it, through increases to mortgage asset values) the actual cash received would be less than that reported in the financial statements. This would result in further cash shortages and require infusion of cash from either shareholders or the public.

The payment of high interest to contract holders relative to the interest earned on investments by the companies contributed to losses in AIC for the entire period.

FIC, on the other hand, showed a substantial improvement over its losses of the early 1970s for 1978, 1979 and 1980. The reason for this was the company's involvement in the stock market. Gains on sales of marketable securities saved FIC from having losses for every year except 1982. (Smaller gains on sales of securities that year left a loss of $5 million before accounting adjustments.)

However, for the year ended December 31, 1983, potential mortgage losses were disclosed in notes to the financial statements (FIC—$10M; AIC—$2.4M). If these losses had been recorded on the income statements, both companies would have shown deficits in retained earnings. (FIC—$7M; AIC—$3M).

The shareholders' equity of the companies as shown on financial statements from 1978 to 1982 was sufficient to meet the capital requirements of the *Investment Contract(s) Acts*. A review of the annual examinations performed by the Superintendent of Insurance for Alberta shows that amounts were disallowed by Alberta regulators for devalued mortgages, real estate, and investments in U.S. depositaries that resulted in significant deficiencies. (Sufficient information was not available for our review to confirm the accuracy of Alberta regulator figures for deficiencies, which were: FIC—1981, $29M; 1982, $35M; 1983, $63M. AIC—1981, $7M; 1982, $11M; 1983, $24M.) Had B.C. regulators investigated underlying values of assets shown in the financial statements or had they obtained the above information from Alberta, they might have had significant cause for concern.

An important point was raised in the annual investigations of the Superintendent of Insurance for Alberta. This was that the statutory capital requirement of a *fixed* amount ($200,000 for B.C. and $500,000 for Alberta) was inadequate for the companies given that they were selling investment contracts in increasing numbers and of a shorter term than before. In fact, the companies increased sales in short-term single payment contracts during this period. These increased from less than 50% to more than 90% of total contracts. Given the companies' "mismatch" of proportionately large investments in mortgages with short-term contract liabilities, the statutory requirement for a fixed amount of capital ($500,000) was considered inadequate. Therefore, as an extra precaution, Alberta regulators also measured the companies' capital on a proportional ("capital ratio") basis every year to ensure that capital amounts were available to cover at least 4% ("25 to 1")

of the companies' liabilities (based roughly on the requirement for trust companies of 5% or "20 to 1").

Alberta regulator reports show that this test was met prior to 1979, but at that point the capital ratio for both companies began to exceed the 25 to 1 limit significantly—a further indication that problems were likely to arise. The capital ratio of 25 to 1 was not a statutory test and the companies were therefore not required to comply (and did not comply) with the Alberta Superintendent's recommendation that sufficient capital be injected to restore the 25 to 1 ratio.

During the period from 1978 to 1983, the companies' mortgages remained at approximately 50% of total investments. Values were questioned by Alberta regulators because of management practices of investing in high risk commercial mortgages, large loans to individual concerns, and the fact that amounts owing on mortgages often exceeded the realizable value of the property against which the mortgages were secured. Following the decline of real estate values in 1982, more than 60% of the companies' mortgages were found by Alberta regulators to be either more than 90 days in arrears or actually in foreclosure. In spite of this, management of the companies did not significantly reduce recorded values of mortgages or real estate in foreclosure. Instead, notes were added at the end of the 1983 financial statements of FIC and AIC which stated:

> Because of the complexities of the real estate market, the economic uncertainties surrounding the underlying values and the present undeterminable value of collateral securities to the mortgages, an estimated additional exposure of $10,000,000 [for AIC, $2,950,000] exists if current market levels represent a permanent, rather than a temporary, decline in value.

In spite of pending losses on the companies' mortgage and real estate investments, in March of 1984 FIC and AIC gave cash of $23.2 million ($22.5M—FIC; $0.7M—AIC) to PS&T for its share of overvalued mortgages and real estate. The exchange was made to assist PS&T in meeting the Canada Deposit Insurance Corporation's more stringent requirements for PS&T's investments. PS&T's own financial statements disclosed that the transfer avoided the recognition of losses in PS&T of approximately $4.6 million. Estimated losses calculated from appraisals obtained by the Superintendent's office in Alberta were closer to $11.3 million on the transferred mortgages.

The exchange was disclosed in the 1983 financial statements of FIC as follows:

> In addition to the exposure relating to mortgages and owned property on hand at December 31, 1983 [$10,000,000 quoted in note above] the Company has increased its exposure by $4,600,000 relating to interests redeemed in mortgages and owned property subsequent to the year end as outlined in note 8(a).

An equivalent note was not included in AIC's 1983 financial statements, presumably because the related loss on $0.7M of transferred mortgages was not considered to be significant.

The Alberta Superintendent recommended that the transfer be reversed as it was "prejudicial to the interest of FIC and AIC contract holders". In response to this recommendation, FIC received $11.3 million in cash in exchange for promissory notes payable to PGL.

Another recommendation made by the Superintendent of Insurance of Alberta based on the financial statements for this period was that, in general, promissory notes payable to PGL should be replaced by permanent share capital. The companies responded by transferring promissory note amounts to shareholders' equity in 1984 (see next section for discussion). It was the view of the Alberta regulators that the notes should have included clauses to require the permission of the Superintendent before being offset against notes receivable from PGL. This was considered necessary to assist in protecting the interests of investors in the event that asset values did not return to their recorded values.

Conclusions

Both FIC and AIC met the "reserve" test for all years in this period except 1983. For 1983, after adjusting for stock values in excess of market and potential mortgage losses, both companies show significant shortfalls in reserves (FIC—$4 million; AIC—$2 million). While 1978 to 1983 was a period of significant growth for the companies, that growth did not provide relief from the problems of earlier periods. Interest rates offered for contracts were increased to remain competitive and ensure the companies' continued operation. This closed the gap between income earned on the companies' investments and the interest paid out to investors to the point where operating expenses could not be covered without relying on gains from sales of marketable securities.

With the significant decline in the real estate market in the 1980s, the companies' proportionately large investment in high risk mortgages began to take its toll in foreclosures of overvalued property.

Necessary capital injections which were recommended by the Superintendent of Insurance of Alberta were not made. For a better assessment of whether the parent company could have provided the necessary capital, regulators would have had to review the financial position of the Principal Group of companies as a single entity.

Finally, it should have been possible for B.C. regulators to determine simply from a review of the annual financial statements that the companies had financial problems which merited further investigation. In particular, there should have been concern at the latest after the receipt of the 1982 annual financial statements, because total income did not exceed expenses (which resulted in a reported loss of $4.3M for FIC and $1.2M for AIC). That cause for concern should have been compounded by notes to the 1983 financial statements which made significant disclosures. The first note to the financial statements that year explained that the dollar figures shown were only reliable if the companies were to continue operations (as a "going concern"). This note then referred the reader to another note which

disclosed potential mortgage losses in sizeable amounts (FIC—$15M; AIC—$3M).

3. 1984–1985

We reviewed financial statements of the companies and the annual financial examinations of the Superintendent of Insurance for Alberta for 1984 and 1985. We note that the companies changed auditors for this period. The "going concern" note to the 1983 financial statements (see previous section) was not included in subsequent annual statements.

1984

A superficial review of the companies' financial statements for 1984 could lead to the conclusion that they were recovering from the poor performance of the previous period. Injections of funds from sales of investment contracts ($60 million—FIC, $5 million—AIC) were used to increase stocks and bond holdings. Escalations in mortgage loans appeared to come to a standstill compared to 1983 as the balance remained at approximately $117 million for FIC and decreased by 13% to $37 million for AIC. Net income increased as the companies paid investors significantly less interest than they received from their own investments.

The increase in net income resulted in improvements in the companies' retained earnings position. FIC's retained earnings increased from $2 million to $3 million and AIC's deficit was reduced from $0.6 million to $0.4 million. In addition, shareholders' equity in total increased (FIC from $3.3 to $10.5 million; AIC from a $0.1 million deficit to $2.3 million).

A closer look, however, revealed that each of these signs was not as hopeful as it appeared to be. The mortgages did not show an increase, but foreclosed amounts transferred to "owned property" almost doubled (FIC from $23 to $39 million; AIC from $7 to $13 million). Meanwhile, annual provisions for losses on mortgages and owned property were not increased accordingly (FIC went from $2.0 to $2.9 million; AIC went from $0.7 to $0.6 million).

The retained earnings figures shown on the face of the financial statements were linked to notes to the statements which disclosed that amounts available were actually deficits (FIC—$7 million; AIC—$3 million). The deficits were caused by the companies appropriating a "reserve" for potential losses in mortgages and real estate in the event that market values did not recover (FIC—$10 million; AIC—$2 million). If these amounts had been shown as expenses, the deficits would have been disclosed on the face of the financial statements. At this point, neither the auditors nor the Alberta regulators were apparently able to conclude definitively that the underlying real estate values were in more than a temporary decline.

The improvements in total shareholders' equity were due to relocating amounts for promissory notes payable to PGL (FIC—$6.2 million; AIC—$2.2 million) from the liabilities section of the financial statements to the

shareholders' equity section. This was probably in response to the Superintendent's recommendation to the companies to convert the notes to permanent share capital. A note to the financial statements declared that management intended to convert the notes to shareholders' equity during 1985. This did not occur in 1985, and in 1986 these amounts were relocated from shareholders' equity back to the liabilities section.

It should have been possible for B.C. regulators to determine, based only a review of the audited annual financial statements, that the companies had financial problems which merited further investigation.

1985

In 1985 the companies paid out more interest to investors and creditors than they were able to earn on their own investments. Gains on sales of marketable securities were not sufficient to cover expenses. The result was net losses. Mortgage balances were decreased because the companies had taken title to properties they had foreclosed. More than one third of the companies' mortgages were now invested in non-producing properties pending foreclosure.

The auditors were by now able to judge that the underlying values of real estate were in more than a temporary decline. Generally accepted accounting principles (GAAP) suggest that a decline in values for more than three or four years should be recorded as a loss. When the companies decided not to record these as losses (FIC—$10 million; AIC—$2 million), the auditors referred to the departure from GAAP in their accompanying report. (When the 1986 financial statements were drafted, the 1985 comparative figures had been restated to allow a "retroactive adjustment" to recognize the losses as actual rather than potential. The resulting net losses for the 1985 year were $18 million for FIC and $4 million for AIC.)

A review of the Alberta Superintendent of Insurance's annual reports on the companies shows that significant reductions were made by regulators for potential losses on mortgages, real estate and assets obtained from related parties at highly questionable amounts.

These reductions resulted in the companies failing to meet the requirements of the *Investment Contracts Act* of Alberta for:

- qualified assets to provide reserves for contract liabilities at maturity,
- qualified assets on deposit at an acceptable banking institution to provide for potential cash pay-outs of contract liabilities before maturity, and
- unimpaired capital amounts from shareholders of $500,000 minimum.

Further capital injections were strongly recommended.

In addition to the injections of capital, the Alberta Superintendent requested that the companies provide business plans to demonstrate their viability.

Conclusions

Increases in foreclosures in this period and interest paid to investors, which exceeded investment income for both FIC and AIC in 1985, with accompanying losses, indicated severe financial difficulties and raised questions as to the viability of the companies.

For a better assessment of whether the companies were viable, regulators would have had to review the financial position of the Principal Group of Companies as a single entity.

4. 1986

Only draft financial statements of the companies were available for our review for 1986.

Significantly, in the 1986 financial statments of both companies, the 1985 comparative figures were "restated" to reflect significant losses on mortgages and real estate (FIC—$10 million; AIC—$2 million). These were the amounts which had led the auditors to express concern about the companies' departure from generally accepted accounting principles in the 1985 statements.

The restated December 31, 1985, deficits for the companies were $15 million for FIC and $5 million for AIC. The companies during 1986 continued to sell investment contracts to investors. FIC's certificate liabilities increased from $314 million to $317 million, while AIC's increased from $96 million to $127 million.

Most of the funds received by AIC were used to purchase qualified assets such as stocks and bonds. In FIC, however, qualified assets declined as adjustments for mortgage and property losses were recorded.

Investments in mortgages and real estate in foreclosure remained the same in total, but with large shifts (FIC—$40 million; AIC—$12 million) from mortgages to foreclosures.

Again, more interest was paid to investors and creditors than the companies were able to earn on their revenue-producing assets. Resulting losses before accounting adjustments were $21 million for FIC and $7 million for AIC. The resulting deficits at December 31, 1986, were $36 million for FIC and $12 million for AIC.

Note 1 of the financial statements of both companies disclosed that:

> The continued operation of the company is dependent on the company and the regulatory body agreeing to a satisfactory resolution regarding the deficiency of assets to the certificate liabilities and reserves and other liabilities together with receipt of provincial licences that allow the company to continue to operate year to year.

Conclusions

A review of the companies' financial statements for 1986 shows quite clearly that the companies had problems which could only have been resolved by the injection of new capital in significant amounts.

General Conclusions

While the companies' financial statements may not have specifically stated that they were having difficulty maintaining themselves as viable business concerns, there were indicators which could have led a careful reader to discover that this was the case:

- large potential losses disclosed in notes accompanying the financial statements from 1983 onward.
- related party promissory notes of significant amounts from 1981 onward.
- large mortgage holdings in times of declines in real estate values.
- significant shifts in the 1980s to single payment, short-term contracts when off-setting assets were mostly long-term; and
- expenses frequently exceeding income from inception.

It was not possible to determine from the financial statements the proportion of contracts held by B.C. residents. However, based on data received from the Alberta court-appointed managers of the companies, of approximately $160 million in contracts held by B.C. residents at the time of the companies' collapse in June of 1987, approximately 90% had purchased contracts after 1983.

Purchase Dates of Investment Contracts Held by B.C. Residents as of July 2, 1987

	FIC		AIC	
year	% purchased during year	cumulative total	% purchased during year	cumulative total
1973-82	5	100	4	100
1982	2	95	3	96
1983	4	93	3	93
1984	16	89	10	90
1985	25	73	22	80
1986	26	48	54	58
1987	22	22	4	4
	100%		100%	

Chapter XII

Analysis and Recommendation

Introduction

The B.C. government chose to take responsibility for the regulation of investment contract companies doing business within the province when it enacted the *Investment Contract Act* in 1962. The statute was set up to provide regulation of the financial marketplace with the aim of protecting investors from unnecessary risks created by misleading practices, inadequate capitalization, or financial mismanagement by companies.

On April 3, 1970, responsibility for the administration of the *Investment Contract Act* passed from the Superintendent of Insurance to the Superintendent of Brokers. That the Office of the Superintendent of Brokers recognized the protection of investors to be its primary purpose was evident when it was asked to formulate its long-term aims by the Research Division of Policy, Legislation and Program Planning in 1979. The Superintendent of Brokers' office stated that one of its goals was to protect investors by ensuring efficient and honest operation, and full disclosure of relevant information in the capital, real estate, and insurance markets.

While it was important that the Superintendent appreciate the need to consider competing interests with respect to the capital markets, the job description for the Superintendent of Brokers, dated January 15, 1980, stated that "the primary goal of all of these activities is the protection of the investing public". The job description for the Deputy Superintendent of Brokers, dated September 1981, indicated that it was his duty

> To safeguard the interests of the public by enforcement of the various Acts and Statutes administered and certain sections of the Criminal Code.
>
> To ensure that the reporting requirements of the various Acts are complied with and all reporting requirements properly disclosed to the public.

The protection of the investing public from unnecessary risks in the marketplace was clearly of paramount concern to the Superintendent of Brokers' office.

As shown in the preceding chapters, this investigation has revealed a regrettable combination of a lack of direction and administrative policy provided by senior members of the Superintendent of Brokers' office and poor or inadequate responses to problems brought to their attention. The reasons for the breakdown in the regulation of AIC and FIC are as important as the failure itself if we are to learn from this experience, which has so seriously affected the lives of thousands of investors.

Why did the regulatory system outlined in the *Investment Contract Act* fail to prevent this tragedy? A number of factors, some of them unusual, interacted to create a situation where no regulator was aware of the magnitude of the companies' problems until they were in serious financial trouble. Had action been taken earlier or more effectively the losses suffered by investors could largely have been prevented. The measures that would have been required were not extraordinary in terms of resources or complexity.

During the entire time that the *Investment Contract Act* was in force no written policy was developed to ensure that its requirements were met. When the Superintendent of Brokers' office was small, staff members interacted freely, and AIC and FIC were looked after by one accountant, the regulation of them at that time, if unstructured, was at least reasonably effective. The effect of a lack of written policy was not so noticeable under such circumstances. However, the practice of assigning one accountant to look after AIC and FIC ceased by 1978. This, in combination with a move to Vancouver that same year, and the hiring of new staff who were not trained with respect to the requirements of the *Investment Contract Act*, led to a problem: no specific individual was left to regulate AIC and FIC. It was then that clear, written policy was most needed. Unfortunately, there was none, and AIC and FIC drifted into 1984 essentially unregulated.

The Superintendent of Brokers' office discovered in May 1984 that there were no financial statements on file since 1978 for either AIC or FIC. They were further alarmed by their review of the 1983 year-end statements, which indicated not only that the companies did not have the required $200,000 in unimpaired capital but also that there was a potential shortfall in qualified assets of $20 million. Had simple regulatory policies been in place, the developing financial difficulties of the companies would have been recognized by the Superintendent much earlier.

The financial crisis of 1984 fell largely into the hands of Deputy Superintendent Jewitt, where it remained until his retirement in May 1986. This period is characterized by a continuous failure of the B.C. regulators to take any action to regulate AIC and FIC, despite the fact that the two senior regulators (Mr. Bullock and Mr. Jewitt) were in possession of information indicating that the companies were experiencing considerable financial difficulties.

By the summer of 1986 a new Superintendent had been appointed and, through the efforts of the Acting Deputy, E.F. Smith, an intensive examina-

tion of the financial affairs of AIC and FIC had been commenced. Regrettably, failure of communication and poor decision-making once again resulted in AIC and FIC not only selling while unlicensed for five months but also being allowed to continue in business in a state of insolvency into mid-1987.

When David Sinclair arrived as Acting Superintendent of Brokers in February 1987, Mr. Smith quickly alerted him to the long-standing financial problems of AIC and FIC. Under the guidance of Mr. Sinclair and his successor Mr. de Gelder, the full powersof the *Investment Contract Act* were invoked and the companies put out of business.

Many approaches can be taken in analyzing the failure of the Superintendent's office to discharge its statutory responsibilities properly in the regulation of AIC and FIC. However, it is of prime importance that any such account should fairly reflect the diverse contributing factors. There was a breakdown due to non-existent policies which led to a situation where individual staff members did not know their responsibilities. But it was not simply a "systems" failure. There were senior regulators who made serious errors of judgement. Yet no one regulator is wholly responsible. Rather, it was the interaction of having no policy guidelines with poor decision-making which prevented successive Superintendents from properly regulating AIC and FIC. In this account we blend our analysis of what happened with suggestions of how simple steps might have been taken that could have prevented the regulatory failure.

Accordingly we begin by outlining the approach a prudent regulator would take in order to carry out his responsibilities under the *Investment Contract Act*. We use this model to guide our analysis of what the regulators actually did. Once the financial difficulties became apparent to B.C. regulators in 1984 we examine how these were handled: first by Mr. Bullock and Mr. Jewitt, then by Mr. Ross and Mr. Smith, and finally by Mr. Sinclair.

Many failures in the regulation of AIC and FIC occurred over the years—some major, some minor, though all contributed to the losses investors suffered.

A Structural Model for the Investment Contract Act

> When I got there and looked at the system long enough to figure out that it didn't make a whole lot of sense and not a lot of people had a really clear understanding about what the review process was and what the actual steps were that had to be taken and why, and that's what initiated the reorganization, and that started literally two weeks after I got there, so we didn't intend to dwell on how information had flowed in the past. We started from the fundamentals. Here is the *Securities Act*. What does it require us to do? Break it down into sections. What are our chief areas of responsibilities, which areas of responsibility go with which others, then draw a picture of those responsibilities and say, O.K., here we have an organization structure based on fundamental roles of the office. And how do we fill those?

This was Neil de Gelder's approach when he assumed his responsibilities as Superintendent of Brokers in June 1987. Mr. de Gelder's approach to the

Securities Act recognizes what a regulator needs with respect to any statute within his jurisdiction: a thorough analysis of the responsibilities imposed upon the Superintendent by statute, and a set of policies developed to ensure these were carried out, together with an administrative structure appropriate to the discharge of those responsibilities. This is what was required in relation to the *Investment Contract Act*. Although individual errors contributed to the breakdown, an appropriate regulatory structure would have greatly lessened the impact that any one person could have had.

Regardless of the statute to be administered, a regulator must:

1. analyze the statute in order to define the responsibilities imposed by that statute;

2. ensure that administrative policies or procedures are in place to discharge those responsibilities;

3. ensure that staff know their responsibilities and are properly trained in the performance of their duties; and

4. ensure that the responsibilities so defined are in fact being discharged.

What, then, were the specific responsibilities of the Superintendent under the *Investment Contract Act*, and what basic policies needed to be drafted to carry these out?

As noted in Chapter IV, the primary responsibility of the Superintendent was to ensure that a company wishing tosell investment contracts in British Columbia was "suitable". Suitability in turn was determined by ensuring that the companies were solvent and that the contracts they were selling would not tend to be a fraud on the buyers of them.

A prudent regulator would develop a system to ensure that he was able to meet his statutory responsibilities. Knowing that he was required to determine the suitability of a company, he would put into place a system to ensure not only that the required financial statements would arrive but also that they would be both reviewed and approved by the accountants as meeting the minimum statutory requirements. The results of the accountants' analysis would then be coordinated with other relevant information pertaining to the issuer's suitability for registration or continued registration. This coordination would be achieved by preparing written policies and checklists and training staff. A written format would ensure certainty and consistency. It would also avoid the difficulties created by frequent turnovers in staff when the person who "knows what to do" leaves. Each of the Departments of Registration, Filings, and Investigations would receive a policy outlining its responsibilities.

The Registration Department would be advised that it was to manage and control the documents that came into the office. It would be directed that prior to the renewal of registration, the registration clerk would ensure that:

1. the application was in the required form and was accompanied by the appropriate fee (section 8);

2. all financial filings of the companies were up to date (section 17);

3. the current financial statements had been sent to the accountants for review (sections 5 and 10); and

4. there were no further matters arising from the application or from a current investigation that might indicate that the applicant was not suitable for renewal of registration (section 9).

If any of these conditions were not met, then registration would not issue. In that event the Superintendent would be advised, inasmuch as it was contrary to the Act for a company to sell investment contracts if it was not registered (section 4). If the conditions were met, the Registration Department would register and diarize the dates upon which both the annual and quarterly financial filings of the companies were next due. Any failure by the companies to meet their filing deadlines would result in the Superintendent being advised.

Once the Registration Department forwarded the financial statements to the accountants in the Filings Department, those statements would be reviewed in order to determine whether the applicant was meeting the statutory requirements. The statute set out three financial tests which a company wishing to be registered had to meet.

Section 5(1)(b) provided a relatively straightforward test requiring the Superintendent to analyze the equity position of an applicant for registration in order to determine that at least $100,000 of the authorized capital stock of the company had been subscribed and paid in cash and that the aggregate of its unimpaired paid in capital and its surplus was at least $200,000. As the term "unimpaired" is not defined in the Act, the Superintendent was required to make a judgement as to whether or not certain assets should be disallowed for the purposes of this test.

Section 5(1)(c) required that in addition to the requirements of 5(1)(b), arrangements satisfactory to the Superintendent had been made for depositing with a savings institution (or other depositary in Canada) "qualified assets" (which had been valued under sections 22 and 23 at values approximating present values) which were sufficient to cover the outstanding liability of the company to its investment contract holders. Section 5(1)(c) allowed the Superintendent to accept a smaller amount where he considered it to be "appropriate".

If the Superintendent did not review the financial statements of the company with regard to analyzing whether or not the assets named were qualified assets, (defined in section 1) valued appropriately, then he could not assure himself that the company met the statutory tests under sections 5(1)(b) and 5(1)(c).

Section 10 required, at the very minimum, that the Superintendent determine that the amount of qualified assets held in reserves were adequate to meet the company's future obligations to its contract holders.

The reserve requirement is the most basic protection provided to the purchasers of investment contracts. The duty of the Superintendent of Brokers under section 10(1) was to ascertain, at least as frequently as the company was required to report, that reserves were at the levels specified by

the Act or, alternatively, to exercise his discretion in a manner consistent with the intent of the Act to allow a smaller amount of reserves where he deemed it appropriate. Subsection (3) provided that the rate of interest which the company used in calculating required reserves not exceed the Superintendent's approved rate. The higher the rate of interest used when calculating the reserve requirement, the lower the calculated reserve would be. A lower rate results in a higher reserve and hence greater protection of the investor. This placed upon the Superintendent of Brokers a responsibility to limit, in a cautious manner, interest rates used in calculating reserves.

The legislation was intended to prevent the sales of contracts by issuers with inadequate capital or insufficient qualified assets on deposit within the meaning of sections 5(1)(b) and (c), or with inadequate assets in reserves as outlined in section 10. Suspected non-compliance with these mandatory provisions would be factors the Superintendent should have in mind when forming his judgement about whether the conditions of section 9(a) had been satisfied so that registration should issue or be renewed.

If the companies did not meet all of the financial tests, a proper process would ensure that the accountants would report the situation immediately to the Superintendent so that he might consider whether to cancel, suspend (section 13) or not renew registration (section 9). These powers allowed the Superintendent to regulate the activities of investment contract companies at any time.

The Superintendent would also establish a mechanism to coordinate information about complaints against the companies with other information about the financial stability and operations of the company. He would instruct the Director of Investigations that, where information relevant to the tests for renewal of registration was found—for instance, from contracts that might tend to be a fraud on their purchasers—the Registration Department should immediately be advised. The Superintendent could thereby assure himself that registration would not proceed if there were questions about the company's suitability arising out of information uncovered by the Investigations Department.

He would also instruct the Director of Investigations to report directly to him any information that would appear to place the company's continued registration in jeopardy.

Recognizing that even the most carefully thought out procedures are sometimes flawed and that individuals make mistakes, the Superintendent would ensure that the staff was trained and understood the policies and their responsibilities. The Deputy or other designate would also conduct reviews from time to time in order to see whether the policies achieved their purpose and whether the staff was carrying them out.

With such an elementary system established, the Superintendent could be reasonably assured that the information which the statute required him to have, in order for him to determine suitability for registration, would be available. He would not be faced with a situation where he did not have the information necessary even to attempt to meet his statutory responsibilities.

1970-1978: The Irwin Years

We turn now from the minimum steps a prudent regulator would take to what the regulators actually did. We begin with the period from 1970 to 1978, when W.S. Irwin was Superintendent of Brokers. Mr. Irwin developed no written policies or procedures with regard to the *Investment Contract Act*. However, his office and his staff, while small, had a very good idea of their responsibilities under the Act, as evidenced by their dealings with AIC and FIC in the early to mid 1970s.

Upon Mr. Irwin's office taking jurisdiction over the *Investment Contract Act* in 1970, he appointed L.G. Smallacombe, one of his accountants, to look after the AIC and FIC files. Mr. Smallacombe believes he continued to do so until Mr. Smith took over in the mid 1970s, although Mr. Smith does not recollect this. Mr. Smith's recollection is that he also ceased to be involved with AIC and FIC by the mid 1970s.

The documentary evidence indicates that each of Messrs. Irwin, Smith and Smallacombe understood the provisions of the *Investment Contract Act*, appreciated the powers of regulation it gave to them, and had no hesitation in wielding those powers whenever necessary. None of them were prepared to accept at face value financial information submitted to them by AIC and FIC. They questioned whether certain transactions were "arm's length", questioned the companies on their definitions of qualified assets, sometimes reducing these values as stated by the companies, disallowed questionable debentures and, on one occasion, forced AIC to obtain, at its own expense, a third appraisal on land owned by it in New Brunswick.

The British Columbia regulators of the 1970s did not only act alone. They were in frequent contact with their Alberta counterparts. There was a close and effective sharing of information. Each province routinely sent the other copies of financial analyses it had performed on AIC and FIC. On one occasion, Mr. Smallacombe travelled to Alberta to attend a hearing Alberta was holding into the continued registration of AIC and FIC.

Nor did the B.C. regulators direct their attention only to financial statements. They reviewed investment contracts submitted to them by the companies for approval. They appreciated that "suitability" for registration was interrelated with the nature of the contracts being sold. They had no hesitation in returning a form of investment contract where they thought it needed amendments.

Where the results of their financial analyses of the companies led them to question whether or not the registration in the province should continue, the Superintendent of Brokers held hearings. As early as March of 1972, Superintendent Irwin ordered a hearing into the continued registration of AIC and FIC, though on this occasion the companies were able to satisfy Mr. Irwin's demands. In the following year, AIC, after a hearing in March 1973, chose to withdraw its application for continued registration in British Columbia, rather than face a refusal by Superintendent Irwin. This instance shows how the Superintendent was able to make use of the "suitability" test for renewal of registration outlined in section 9 to force AIC to shut

down its operations in the province. AIC was not re-registered to conduct business in British Columbia until January of 1978.

In 1974, when Mr. Smith noted a subordinated promissory note payable by FIC to PGL, he wrote to Mr. Marlin demanding that the note be redrawn so that the prior approval of the Superintendent of Brokers in British Columbia would be obtained before it could be repaid. Mr. Marlin attempted to provide various alternatives to redrafting the note, but Mr. Smith refused them. The result was that approval of registration for FIC was held up until April 25, 1974.

It might finally be noted that Superintendent Irwin was both aware of and prepared to use his powers to cancel licences pursuant to section 13 of the statute. Afterreviewing the June 30, 1974, quarterly financial statements from FIC, Mr. Irwin demanded cash injections immediately, upon threat of cancellation of the company's licence to operate in B.C.

While it is possible to cite areas where policy was not developed or strict attention to the details of the statute was not given, it is evident from the foregoing that the lack of written policy did not have a significant effect upon the regulation of the companies during the early to mid 1970s. However, there was one significant misunderstanding which occurred because there was no written policy, and it was a harbinger of problems to come. The accountants—in particular E.T. Jewitt, E.F. Smith, and L.G. Smallacombe—believed that it was the responsibility of the Registration Department to ensure that quarterly financial statements were filed. The Director of Registration, on the other hand, believed that it was the responsibility of the accountants to ensure that quarterly financial statements came in. In his view the Registration Department was responsible solely for ensuring that annual financial statements were filed. While this discrepancy in views did not cause problems as long as one accountant looked after AIC and FIC, this general lack of written policy, of which the above is but one instance, was to cause fundamental problems in the regulation of AIC and FIC from this point on.

This period may be summarized by stating that generally the companies were closely and effectively regulated while one accountant was designated to monitor their affairs. The full powers of the *Investment Contract Act* were applied, and consequently the lack of formal written policy did not unduly affect the regulation of AIC and FIC.

1978—1984: The Transition from Superintendent Irwin to Superintendent Bullock

The consequences of the lack of clear written policy noted in the previous section came to the fore in the late 1970s. Certainly by 1978 there was no longer an accountant monitoring the affairs of AIC and FIC.

Mr. Jewitt, at that time the Director of Filings, did receive from the Registration Department some quarterly financial filings from FIC during 1978, which he looked at and filed. However, as noted previously, he did not, by

virtue of this involvement, see himself as having "taken over" the responsibility for monitoring the affairs of investment contract companies.

Unfortunately, along with the fact that no new accountant was appointed to monitor the affairs of AIC and FIC, the Office of the Superintendent of Brokers moved from Victoria to Vancouver in the fall of 1978. In the process it acquired almost completely new staff. Only Mr. Irwin, Mr. Jewitt, the Deputy Superintendent, and the Director of Registration moved to Vancouver. The Director of Registration believed that companies ought to have their renewal of registration contingent upon an accountant's approval of their annual financial statements. However, as he noted in his testimony, he never trained any of his new staff with regard to the specific requirements of the *Investment Contract Act*. We interviewed the registration staff who worked in the Department from 1978 to 1983. The clerks who actually processed the registration renewal were of the view that renewal could proceed so long as an appropriately completed application was filed along with the requisite fee. They had limited or no knowledge of the *Investment Contract Act* and certainly were not looking for financial statements. The failure to name a new accountant with responsibility for monitoring AIC and FIC, in combination with the Director of Registration's failure to train his staff with regard to the requirements of the *Investment Contract Act*, led to a situation whereby the companies were essentially unregulated until 1984.

The simple expedient of a written policy outlining the requirements which must be met prior to renewal of registration could have prevented this situation. The clerk would have noted that no financial statements had been received and would not have renewed registration.

The situation might have been improved on the arrival of Rupert Bullock, who became the Superintendent in mid January of 1980. Mr. Bullock testified that upon beginning his tenure he read all the statutes over which his office had jurisdiction. He set his sights on the *Securities Act* and decided to consolidate, streamline, and develop policy for that statute. He told us that he paid little attention to the *Investment Contract Act* because only two or three companies were registered under it. When we asked him what he thought was going to be done with regard to monitoring investment contract companies, he answered that it was his expectation that the office would continue to do whatever it was that it had been doing. It is unfortunate that he did not discuss with his Deputy Superintendent, Mr. Jewitt, precisely what the office was doing in this regard. Had he done so, it would have become apparent to them both that nobody was monitoring AIC and FIC.

Mr. Bullock stated that because of the volume of work facing his office he did not have enough time to do everything and that consequently he turned his attention to the more important *Securities Act*. This missed the point. He was not required to redraft the *Investment Contract Act*, but had the duty to review his office's responsibilities pursuant to it so that he could be assured that the requirements imposed upon him were being met. Mr. Bullock ought simply to have asked Mr. Jewitt what procedures were in place to ensure that the requirements imposed upon the Office of the Superinten-

dent of Brokers by the *Investment Contract Act* were being met. Had he done so, he would have been told, as Mr. Jewitt told us in testimony, that Mr. Jewitt did not know. Such an inquiry by Mr. Bullock in 1980 would have led to the realization not only that someone should immediately monitor the affairs of investment contract companies, but also that written policy needed to be developed to ensure that such a situation did not recur.

It would not have been difficult for Mr. Bullock or Mr. Jewitt to put together a policy in order to ensure that the statutory responsibilities were met; nor would it have been particularly time-consuming. It is not sufficient for Mr. Bullock to suggest that there was not enough time even to determine whether or not the office was doing what the statute required it to do.

It was not until May of 1984 that the Office of the Superintendent of Brokers recognized the fact that nobody had been monitoring the financial suitability of AIC and FIC since approximately 1978. It is Mr. Jewitt's belief that the companies had failed to file any financial statements since 1978, as a search by him of the office's files revealed none. This extraordinary state of affairs led to discussions involving Mr. Jewitt, the Senior Inspector of the Investigations Department, and the Acting Director of Registration. These discussions did not lead to the preparation of comprehensive written policies to monitor investment contract companies. They led only to the setting up of a system intended to ensure that quarterly financial statements for these companies came in, although even this system did not work as it was intended to.

Mr. Bullock was informed by copy of the May 29, 1984, letter from Mr. Jewitt to Mr. Saleh, the Alberta Superintendent of Insurance, not only that AIC and FIC had apparently failed to file financial statements but also that according to his Deputy they had a potential shortfall in qualified assets of more than $20 million.

We have noted in the preceding model the importance, once policies and procedures were drafted, of somebody checking to ensure that they were being followed or that they were working. It does not appear that anyone in the Superintendent's office ever checked to see whether the newly introduced "bring forward" system for quarterly financial statements was working properly. Had they done so they would have realized that their diary system was inadequate. Letters were going out to AIC and FIC demanding that they submit their quarterly financial statements before they were due; demands were frequently made pursuant to the wrong statute; not all their demands were met; all the required quarterly statements did not arrive; several persons dealing with AIC and FIC were not even aware of the existence of the *Investment Contract Act*; and on at least two occasions when financial statements did arrive that fact was not recognized and second demands for the same documents were sent out. While these lapses may not be of fundamental importance, they indicate a continuing disregard for the need to meet the statutory responsibilities under the *Investment Contract Act*.

Notwithstanding problems which came to his attention and which indicated a lack of monitoring, including the absence of financial regulation for several years and indications of a significant potential shortfall, Mr. Bullock failed to set clear policies and procedures to ensure the proper administration of the *Investment Contract Act*.

May 1984 to May 1986: Mr. Bullock and Mr. Jewitt

Earl Jewitt was the first person to recognize that AIC and FIC were operating in British Columbia with a potential shortfall of at least $20 million. His recognition of the possibility that the companies were operating in contravention of the *Investment Contract Act* should have led to a full investigation of the companies' financial position. He failed to discharge this responsibility adequately and thus played a pivotal role in the losses investors were ultimately to suffer.

Mr. Jewitt was an experienced chartered accountant who had worked in the Office of the Superintendent of Brokers since 1966. Before becoming Deputy Superintendent of Brokers, he had been the Director of Filings (Chief Accountant). Most of his work was in the securities field. The investment contract companies were a small part of his responsibilities, and our comments on his regulation of them should not be taken to imply any criticism of him in any other sphere.

It is also important to emphasize that from the move to Vancouver in 1978 onwards, the office was understaffed and overworked. Mr. Affleck noted that staff frequently had to work exceptionally long hours under trying conditions. Mr. Jewitt also suffered from increasingly poor health.

Neither Mr. Jewitt nor his superior, Mr. Bullock, had ever analyzed the responsibilities to the investing public imposed upon them by the *Investment Contract Act*. No formal policies or criteria had been developed to guide the accountants in their measurement of the companies' compliance with the capital requirements of the Act. No person had been designated to assumeresponsibility for monitoring the companies, and there were apparently no discussions between Mr. Jewitt and Mr. Bullock about those responsibilities. Mr. Bullock's several statements to us that the investment contract companies were within Mr. Jewitt's job description and that he relied on Mr. Jewitt to discharge those responsibilities do not relieve him of ultimate responsibility. Investment contract companies were in Mr. Bullock's job description alone until mid 1981; after that, they appeared in the job descriptions for both Mr. Jewitt and Mr. Bullock.

As Superintendent, Mr. Bullock had a clear duty to review and define his obligations under the *Investment Contract Act* and to ensure that there were people and measures in place to carry them out. While it was undoubtedly necessary for him to assign priorities in view of his considerable workload, it was not correct for him to assign those priorities without knowing the full extent of his responsibilities. If Mr. Jewitt was to be responsible for the investment contract companies, it was up to Mr. Bullock to articulate that

delegation of responsibility formally and to inform himself about their regulation from time to time.

In this vacuum of financial regulation, Mr. Jewitt sat down to review the 1983 year end financial statements in May of 1984. By "writing down" the values of securities and real estate interests from cost to market values he identified a potential shortfall of at least $20 million which needed to be looked into. He also realized that if the companies were forced to sell their assets at liquidation values the shortfall might be much greater.

As no policies for the analysis of financial statements had been developed, it is not clear what criteria Mr. Jewitt used in calculating these deficiencies. He told us he was not familiar in any detail with the capital requirements of the *Investment Contract Act* and thought that he had made no reference to it for the purpose of these calculations. We note, however, that the Act required the value of these assets to be calculated at market value, and it may be that Mr. Jewitt failed to do himself justice in this respect in his evidence before us.

Having identified the concern, Mr. Jewitt took two appropriate steps: he wrote to Alberta to advise them of the potential deficiencies and to enlist their assistance, he reported the problem to his superior, Mr. Bullock, by sending him a copy of the letter to Alberta. He attempted to communicate his concern to the Registration and Investigations Departments, which needed this information in order to discharge their own responsibilities, by also sending copies of the letter to the department heads.

At the same time, he discovered that neither the annual statements for the years 1978-1982 inclusive nor the quarterly statements for the years 1979-1983 inclusive were in the files he reviewed. He concluded that the companies had failed to file them. If Mr. Jewitt thought the companies had been failing to file the statements, which he did, one would have expected him to investigate that failure and to obtain any statements which were available. As our financial review confirms, had he taken this step it would have been evident, at least in the 1982 year-end statements, which were required to be filed by March 31, 1983, that the financial condition of the companies was deteriorating significantly and that the public was increasingly at risk.

Mr. Jewitt realized, in light of the lack of financial statements, that the administrative systems in his office had failed, and in his subsequent meeting with the Acting Director of Registration, he attempted to ensure the problem would not recur by having a computerized quarterly prompt system implemented. Although it was an inadequate attempt to address the problem, at least Mr. Jewitt attempted to take a third appropriate step.

As we have noted, the system worked ineffectively because the Acting Director failed to ensure that the staff who had to implement it understood the statutory framework in which it was to operate and also failed to monitor the system to make sure it was functioning properly.

Why were these steps insufficient? In part, because those with whom Mr. Jewitt communicated failed to respond adequately or appropriately, as dis-

cussed in further detail below. Ultimately, however, we have to conclude that it was Mr. Jewitt's individual failure to monitor the situation closely enough, his unfounded belief thatAlberta would provide assistance,* and his failure to consider properly the regulatory alternatives available to him which permitted the companies to continue to operate past the point where prudent regulation would have demanded that their licences be cancelled.

What steps did Mr. Jewitt take to follow up on his request for Alberta's assistance? As we have seen, Mr. Jewitt did not personally diarize the need for a response from the Alberta regulators to his May 29, 1984, letter. He and Mr. Bullock did discuss sending in a British Columbia investigator to do an independent evaluation in Alberta, but they decided that it would be redundant since they believed that Alberta had the matter in hand and would keep them advised. At some point Mr. Jewitt spoke to the Alberta regulators, and on July 3, 1984, he advised the Acting Director of Registration that he expected a report from the Alberta regulators within two weeks at which point he would review the status of the companies. Mr. Jewitt did not diarize that date and the promised report never arrived.

Mr. Dilworth, as the result of a discussion between his senior inspector and Mr. Jewitt over the missing financial statements, had decided to keep track of Alberta's progress and had set up his own monitoring system on May 29, 1984. Mr. Dilworth cannot remember whether he told Mr. Jewitt he was doing this. Although he could not clearly remember discussing the problem with them, he thought Mr. Jewitt and Mr. Bullock had the situation in hand.

While it may have been reasonable, there was little basis in fact for Mr. Dilworth's assumption about the state of Mr. Jewitt's knowledge and his supposed continued monitoring of the situation. Over the course of the next twelve months, Mr. Dilworth had a junior inspector, make several telephone calls to Alberta. The first of these occurred in August of 1984, and the inspector was instructed by his supervisor to first contact Mr. Jewitt for information. He did so on August 15, approximately four weeks after Mr. Jewitt had anticipated receiving the critical report from Alberta.

The inspector's memorandum does not seem to have triggered Mr. Jewitt to take prompt and effective action, despite the magnitude of the potential shortfall suspected by him. Rather than calling Alberta himself, he suggested that the junior inspector call a senior regulator in Alberta. Mr. Jewitt received a report on the telephone call which he said gave him the impression that there might be some slight hope of improvement. The report also indicated that there were continuing discussions between the regulators and the companies. The promised Alberta report was not mentioned, and Mr. Jewitt apparently took no other action to obtain it, stating to this office

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*Indeed, the Code Report states: it was not the practice of [Alberta's Ministry of Consumer and Corporate Affairs] to provide copies of either the annual examination reports or correspondence with the companies to the external auditors. [25724; 2795-6]. Nor was it the practice...to provide copies of annual examination reports *or convey the findings to the regulators in other provinces where FIC and AIC certificates were sold.* [25338-9; 28831-2; 34655] [emphasis added]

that he considered the brief reply by Alberta to the junior inspector to satisfy his reporting needs.

The inspector called Alberta again on September 28 and November 27, 1984. On the latter date he reported to Mr. Dilworth that Alberta was determining the amount of a capital injection. He reported that the Alberta Superintendent of Insurance had told him there was nothing to worry about. In light of the Code Report findings, that statement was not an accurate summary of Alberta's views, and it must have misled the B.C. regulators.

It is not clear whether the results of these conversations were reported to Mr. Jewitt or not, although Mr. Dilworth states that this would have been the normal practice. In the meantime, however, Mr. Jewitt had taken no further action other than one or two telephone calls to Mr. Saleh. It was now six months since he had first identified the potential $20 million shortfall.

Indeed, the files reveal no further action of any kind by anyone until March 5, 1985, when the junior inspector again called Alberta. As a result, Mr. Jewitt was advised that PGL had injected $11.3 million, that the "financials are now acceptable", and that the situation was "under control". Again, in light of the Code Report, and what it reveals about Alberta's state of knowledge at that time, this was not an accurate statement.

Although Mr. Jewitt said that this information gave him some comfort, in a memorandum to Mr. Bullock of March 15, 1985, he recommended that they "continue a close monitoring". By then, the 1984 audited annual statements had arrived and they were sent on to Mr. Affleck for a review. Again, Mr. Jewitt's conduct in this respect was not inappropriate in itself. Unfortunately, Mr. Affleck's review was neither detailed nor comprehensive. The 1984 statements did not contain a "going concern"note, and as our financial review indicates, a quick review might have indicated that the companies were recovering from their previous poor performance. A more careful review would have revealed that foreclosures had almost doubled but that the allowance for losses in this area had not been correspondingly increased. Although total shareholders' equity had improved, that was only because the companies had moved amounts for promissory notes payable to the parent from the liabilities section of the financial statements to the shareholders' equity section.

The one point Mr. Affleck drew to Mr. Jewitt's attention was that the companies had appropriated a "reserve" for potential losses and mortgages, but the reserve had created or increased deficits. This technique avoided the disclosure of large losses on the face of the financial statements. Mr. Affleck reported to Mr. Jewitt in two memoranda on the subject. Copies of them were sent to the Superintendent but there is no indication that Mr. Bullock took any action as a result; nor did he recall taking any.

Mr. Jewitt and Mr. Affleck decided to deal with the unusual presentation in the financial statements by seeking the advice of the Canadian Institute of Chartered Accountants. Although this decision was made on April 3, Mr. Affleck did not write to the CICA until July 8. They responded by declining to comment and suggesting that B.C. write to the companies and their audi-

tors directly. Mr. Affleck did so, but failed to follow up when he received no response. In the meantime, Mr. Jewitt had taken no other action. There the issue died.

When the junior inspector called Alberta again on August 9, 1985, just over 14 months had gone by from Mr. Jewitt's identification of the potential $20 million shortfall and no effective independent action had been taken by British Columbia in response. The inspector's report to his superior, Mr. Dilworth, indicated that Alberta's independent regulatory audit for 1984 was underway, but that there were significant matters in dispute and indications of a deficiency in the $5 to $8 million range. The junior inspector reported that he had been told by Mr. Rodrigues of Alberta that although there was a suspected deficiency, the companies had made a profit in 1984 and there was adequate provision for loss exposure in their real estate investments. Again, one has to question any such assurance in light of the Code Report. It is not clear whether or not this information was relayed to Mr. Jewitt, and in the meantime, Mr. Jewitt had taken no action himself.

On August 20, 1985, Mr. Jewitt asked Mr. Affleck to look at AIC's 1984 annual financial statements. Mr. Jewitt had apparently forgotten that he had already asked Mr. Affleck to do this and had indeed received a report on them. Nor in his memorandum to Mr. Affleck is there any indication that he recalled the earlier discussions of these issues. He took no further action until October 1, 1985, when he sent the March 31 and June 30, 1985 quarterly statements for FIC, about which he was quite properly concerned, to Mr. Affleck for review stating "These statements do not look good. Any comments."

On November 21, 1985, almost 18 months after Mr. Jewitt had first identified the potential $20 million shortfall and a few days after receiving a letter from an investor who referred to a rumour that Principal was "going down", Mr. Jewitt wrote to Mr. Saleh expressing his increasing concern about the financial position of the companies and requested information. He said:

> ...we feel that we must make a decision with respect to these companies in the near future. People are investing in these companies, and it may very well be that the companies are not meeting the statutory requirement.

By way of response, Mr. Jewitt received a letter from Mr. Rodrigues, the Deputy Superintendent of Insurance in Alberta, which contained far from complete information about the concerns of the Alberta regulators. Mr. Rodrigues suggested that British Columbia might want to pursue its concerns independently.

This should have been a warning to Mr. Jewitt that he was not receiving full cooperation or information from Alberta and that there were serious concerns which could no longer be ignored. Instead, he briefly reviewed the *Investment Contract Act* and erroneously concluded, without sufficient information, that the companies were probably meeting British Columbia's

statutory requirements. He advised Mr. Rodrigues in his letter of December 18, 1985:

> In these circumstances, it would appear that the companies are probably well within our statutory requirements, even though they may well be in a serious financial condition.

Mr. Jewitt had no sound basis for that conclusion, as he acknowledged in his evidence before us.

On January 20, 1986, Mr. Jewitt became Acting Superintendent of Brokers. He apparently took no further action until mid April, when he phoned Mr. Rodrigues. Mr. Rodrigues told Mr. Jewitt that Alberta had received legal advice to the effect that the companies were *not* in contravention of the Alberta *Investment Contracts Act*.

On April 30, 1986, Mr. Jewitt sought a legal opinion himself. His memorandum seeking that advice again reflects his impression that the *Investment Contract Act* was weak. It also reflected his view that the companies were not in contravention of the Act, despite what he knew to be their serious financial condition. Had there been a proper analysis of the capital requirements of the *Investment Contract Act* and the financial statements submitted pursuant to it, it would have been impossible for Mr. Jewitt to reach this conclusion.

It was not inappropriate for Mr. Jewitt to seek legal advice on his regulatory options, but it was a significantly inadequate and belated response to the situation. Mr. Jewitt was also unaware that at that point the companies had been selling investment contracts while unregistered in B.C. for 30 days. He was aware, however, that by this time the audited annual financial statements for 1985 were late. He and Mr. Affleck began to discuss what steps they might take, but before any regulatory action was taken, Mr. Jewitt retired. Exactly 24 months after he first identified the potential $20 million shortfall, and after the companies had been selling investment contracts while unregistered for 61 days, his tenure came to an end.

In our view, it was appropriate for Mr. Jewitt to seek assistance from Alberta. There was a long-standing practice of communication with and disclosure to the neighbouring jurisdiction. As well, Alberta had carried out independent audit inspections of the companies' operations and therefore had information which was not otherwise readily available. It was critical, however, that turning to Alberta did not constitute a total reliance and thereby become a substitute for discharging British Columbia's own responsibilities under the *Investment Contract Act*. As the Code Report demonstrates, the extent of the reliance on Alberta was disastrous, inasmuch as the Alberta regulators were subject to political direction which prevented them from taking steps they thought necessary.

What is clear is that while he was waiting for Alberta, Mr. Jewitt did not attend to the situation. While we do not know what information Alberta would have disclosed if Mr. Jewitt had pressed them, there would have been one of two results. First, sufficient information might have been obtained to identify the major financial crisis that existed. The Code Report

notes that by 1984 the companies were known by Alberta regulators to be insolvent. Alternatively, it might have become clear that Alberta could not or would not provide adequate information, in which case British Columbia would have known that it was immediately necessary to pursue the matter independently. By not ensuring that Alberta provided sufficient information, Mr. Jewitt precluded the possibility of effective action.

Apart from his total reliance on Alberta, Mr. Jewitt sacrificed the interests of new investors to the possibility that the companies might be able to work their way out of their difficulties. Clearly, a prudent regulator must balance a number of interests which may sometimes conflict. Fundamentally, however, there was the duty to administer the statute in accordance with its terms. At the same time, if there was any *real* possibility that the companies would be able to recover then it would have been irresponsible (given the duty to existing investors) to take precipitate regulatory action which would lead to their collapse. But that assessment could only be made on the basis of more detailed information about the present situation of the companies. Mr. Jewitt never had the requisite information to make that assessment nor did he make adequate attempts to obtain it.

Mr. Jewitt was uncertain as to what regulatory powers the Act provided; he concluded that the *Investment Contract Act* was "very weak" and presumably that his regulatory options were therefore limited. However it took him two years from his recognition of problems with AIC and FIC to seek a legal opinion on his options. Consequently, Mr. Jewitt failed to have appropriate concern for the interests of both existing and new investors. It is worth noting that neither his predecessor, Mr. Irwin, nor his successors, Mr. Sinclair and Mr. de Gelder, had difficulties using the powers of the Act to regulate AIC and FIC effectively.

But the responsibility does not lie solely with Mr. Jewitt. Mr. Bullock failed to appreciate the seriousness of the situation. He told us that perhaps the fault lay in the way the information was initially presented to him in that it was not sufficiently flagged for hisattention. We note, however, that there was at least one discussion subsequent to the May 1984 discovery between Mr. Jewitt and Mr. Bullock (about whether to send investigators into Alberta) and that Mr. Jewitt routinely sent copies of his memoranda and correspondence to Mr. Bullock until the end of 1985. While it was clearly reasonable to delegate responsibility initially, once a problem of this magnitude had been identified Mr. Bullock had a continuing duty to make himself aware of the progress of the investigation, including whether adequate information was received from Alberta and adequately reviewed, and to ensure that the steps taken were effective. As well, had Mr. Bullock delineated clear policies and criteria for the administration of his responsibilities under the *Investment Contract Act*, many of these problems would not have developed to the extent they did.

June 1986–February 1987: Mr. Smith, Mr. Edgar and Mr. Ross

On June 1, 1986, Bill Smith became Acting Deputy Superintendent of Brokers and David Edgar became Acting Superintendent. Mr. Edgar was only to act as Superintendent until Michael Ross assumed the permanent appointment on June 23. Neither Mr. Smith nor Mr. Edgarwere briefed on the continuing problems with AIC and FIC, although Mr. Affleck continued in his position with knowledge of the difficulties. The 1985 year-end financial statements had still not arrived by June 1, and the companies had by then been selling without being licensed to do business in the province for two months.

We have said that a prudent regulator must define his responsibilities under the statute he administers and must ensure that there are policies established to carry out those responsiblities. Although Mr. Jewitt had not, in his brief role as Acting Superintendent, conducted any adequate analysis of the Act, and had not created any policies, Mr. Smith was quickly able to identify the key capital requirements under the Act, and he carried out a thorough analysis of the 1985 year-end financial statements once he was able to obtain them. It is again worth noting that it was only by accident that Mr. Smith obtained those statements.

He very quickly identified potential deficiencies of more than $55 million for the companies and immediately brought the problem to the attention of his superior, Mr. Edgar. The criteria he used for calculating the deficiencies appear to be consistent with the *Investment Contract Act*. His sense of the regulatory options was that very firm and emphatic action had to be taken: either the companies were to have their registration renewed and then suspended, or a hearing should be convened to determine whether the companies were suitable for renewal of registration. However, he questioned whether either option was viable and because his information was limited, his preference was therefore to obtain an independent expert report. Mr. Smith was unaware of the regulatory history of the companies and he did not research that history. Had he been properly informed, he would have realized that there had already been considerable delay and that little concrete information had been received from Alberta. As it was, Mr. Smith responded appropriately to the information he had at that stage. He reviewed and analyzed it forcefully and quickly and he informed all of the appropriate parties about it.

On June 13, he and Mr. Edgar met, along with Mr. Affleck and a lawyer from the Legal Services Branch. Because Mr. Edgar was unaware of the regulatory history to that point, he also placed a reliance on Alberta to take the lead, which was unrealistic in view of the information that had been requested but not received from Alberta inthe preceding two years. He stated that he would not have been prepared to release financial statements to the public. With respect to the continuing sales of investment contracts while the companies were unlicensed, Mr. Edgar stated in testimony to this office that his concern was not so much for the investor as it was for the

companies, who might not be able to enforce their contracts. In subsequent submissions to this office, Mr. Edgar made the point that what he had meant to convey was that although his concern was with the protection of the investing public, he believed that that end would be best achieved by appealing to the companies' self-interest. However, his telephone call to Mr. Johnson of PGL stating this concern and requesting that they cease selling investment contracts was apparently taken as a signal of regulatory weakness by the companies, as Mr. Smith noted. It is fair to note that Mr. Edgar acted in the position of Superintendent for a very brief time, during which Mr. Smith was known to be aggessively pursuing additional information.

By the time Mr. Ross became Superintendent on June 23, Mr. Smith had already managed in a matter of days to convene a meeting with Mr. Johnson of PGL and Mr. Marlin of AIC and FIC. Mr. Smith acted quickly and effectively to obtain as much information as possible and, indeed, the companies provided him with financial statements and other information for a number of the related companies. The argument that the Act was too weak to be used to take effective regulatory action cannot be sustained in the light of Mr. Smith's achievements.

Mr. Smith worked hard to analyze all of the information he had obtained and he reported very fully to Mr. Ross in his memorandum of July 2. Within a short time he had completed a detailed review. Indeed, Mr. Smith made every effort to bring the situation to an appropriate resolution. He was aware of the requirements of the *Investment Contract Act*, he analyzed in great detail the information he had and, where needed, he obtained as much additional information as possible. He communicated fully with those who needed to be aware of the situation.

He was not overly reliant on Alberta. He had some communication with Alberta, but it seems always to have been clear to him that it was necessary for British Columbia to accept independent responsibility. His sense of the weight to be accorded to the different factors a prudent regulator had to take into account in the circumstances was also appropriate. Once it was clear that the companies were not going to provide a quick cash injection, he was emphatic in notifying Mr. Ross that "continued operation in the twilight zone" could not be permitted and it was clear to him at that point that the operations of the companies should cease.

We have to ask why the effective and appropriate steps Mr. Smith took were not sufficient to resolve the problems. Whereas Mr. Jewitt's failure was at least to some extent individual, Mr. Smith's inability to resolve the situation was largely the result of inadequate and inappropriate responses from those to whom he reported.

It is reasonable to conclude that these inadequate responses and lack of support for his recommendations discouraged Mr. Smith and affected his subsequent actions with respect to the companies, as it is otherwise difficult to explain why he was prepared to accept an injection of "assets" in late August without more than the most superficial review of what was actually tendered. Given his previous unwillingness to accept the assurances of the companies at face value, it is surprising that he was prepared

to accept Mr. Marlin's assurances in the meeting of August 27, 1986, that there had been an injection of qualified assets.

Mr. Smith had first identified a possible shortfall of more than $55 million, which, with further and considerable review, he reduced to $11.3 million; under the circumstances it was improper for him to accept an injection of assets asserted to be qualified without even reviewing the documents involved on such basic questions as title to the assets. As at the date of this report, it is still unclear what benefit investors will receive from this transaction as the funds obtained by AIC and FIC as a result of the realization of the security attached to these assets are subject to claims by PGL noteholders and others, which may result in litigation.

After August 27, Mr. Smith was much less involved. Even though he was no longer formally seconded to the Office of the Superintendent of Brokers (his term ended July 31, 1986), he voluntarily accepted the responsibility of providing Mr. Ross with a very detailed analysis of the quarterly statements to September 30 in his memorandum of November 5. He also voluntarily and spontaneously took on the obligation of briefing Mr. Ross's successor, David Sinclair, in February 1987. As well, he briefed Mr. Mulligan and the new Director of Registration.

In summary, Mr. Smith was negligent in accepting the assets tendered on August 27, 1986, on the basis of a very superficial review which did not touch on the legal documents involved or whether the assets were qualified under the *Investment Contract Act*. Mr. Smith implied that he took the measure of those with power to make the final regulatory decisions and in accepting the assets tendered he did what he felt was the best he could do under all of the circumstances. Otherwise Mr. Smith acted properly and efficiently, and the efforts he took to come quickly to grips with a complex situation sharply contrasted with those of Mr. Jewitt.

Michael Ross assumed responsibility for an extremely busy office and it is perhaps not surprising that in the early days of his superintendency he had no time to do more than read Mr. Smith's July 2, 1986, short summaries of the AIC and FIC problems, rather than reviewing the 11-page memorandum in detail. Unfortunately, his definition of his role may well have prevented him from properly discharging his duties under the *Investment Contract Act*. His interest was in management and systems, and his goal was to increase the turn-around time for prospectuses. His evidence makes it clear that he never attempted to review and define his responsibilities under the *Investment Contract Act*. As a result, the preparation of policies to carry out those responsibilities never became an issue for him.

Like Mr. Smith, Mr. Ross was not briefed on the regulatory background of the companies even though he took the trouble to have meetings with Mr. Bullock and Mr. Jewitt. Neither mentioned the problems they had encountered with the companies. On the other hand, it appears that it did not occur to Mr. Ross to require information about the regulatory history once Mr. Smith had informed him of the current problems. Unlike Mr. Smith, but like Mr. Jewitt, he was prepared to take the lead from Alberta and he thought it was "mischievous and irresponsible" to take any precipitate reg-

ulatory action if there was any chance at all that the companies might survive. Whereas Mr. Jewitt made that assessment without adequate information, Mr. Ross had acquired sufficient information to indicate very serious financial problems, but in so doing he failed to give proper weight to the interests of both present and future investors.

What steps did he take? First of all, he delegated almost all of the responsibility for regulating the companies to Mr. Smith while at the same time he failed to follow Mr. Smith's recommendations for regulatory action. He made the decision to allow the companies to continue to sell investment contracts even though he knew there were significant deficiencies in qualified assets and even though he knew they were unlicensed. Because he knew Allister McPherson at the Treasury Department in Alberta he thought he could rely on Alberta to take appropriate action. Without the knowledge of the regulatory history it was not surprising that Mr. Ross should have wanted the report of an independent consultant. Mr. Smith had made the same recommendation to Mr. Edgar, and it was obviously very difficult to take any regulatory action that might precipitate a collapse based only on an accountant's quick review of various financial statements. It was clearly reasonable to believe that there should be an independent and reliable review of the underlying assets.

That reasonable decision, made in isolation from information available about the regulatory history, led to further continuing abdication of responsibility on the part of British Columbia regulators. After the claimed capital injection on August 27, 1986, there was essentially no further action taken until the quarterly statements of September 30, 1985, came in at the end of October. At that point, it was again Mr. Smith who provided the only comprehensive analysis of the steadily deteriorating position of the companies, and the response of Mr. Ross was to make a few more telephone calls to Alberta. Those calls revealed that the independent consultant had not yet been appointed and indeed the independent consultant did not begin work on this task until January, 1987. While the concept of appointing an independent consultant was not unreasonable, as we have noted, the idea had first been suggested in June, 1986, and it is clear that the claimed capital injection in August was only intended to be an interim measure until the true picture could be determined by the consultant. Mr. Ross allowed the situation to deteriorate, while he knew new investors were purchasing contracts.

Mr. Ross's telephone calls to Alberta were the only regulatory action he took with respect to AIC and FIC after August 28. He estimated that during the entire period of his superintendency he made at most six telephone calls to Alberta, of which he kept no notes. When we asked Mr. Ross whether he considered holding a hearing after the results of the September 30 quarterly financial statements were known, he told us:

> ...we still didn't know in the long run whether the companies were viable or not and if I had done that [cancelled the registration] it would again be tantamount to putting them out of business without knowing whether they

> would be long term viable or not. I thought that would be mischievous and irresponsible.

While that view may have been appropriate during the initial phases of Mr. Ross's superintendency, it was not appropriate after he knew that what was assumed to be a significant capital injection had failed even to stabilize the companies and the picture was seriously deteriorating. Again, had he known the regulatory history and had he appreciated that sufficient information had never been obtained from Alberta, it would have become clear to him that British Columbia had to proceed with greater dispatch and on its own.

Mr. Ross resigned effective February 2, 1987, without briefing his successor, and without leaving memoranda and files documenting the steps he had taken. What can we learn from Mr. Ross's superintendency? Without a doubt, he inherited a crisis and was not fully briefed by those who knew most about it. Initially, at least, it was not unreasonable for him to depend on Mr. Smith, who had already begun an intensive analysis of the companies, or to want to obtain Alberta's assistance. Had Mr. Ross and Mr. Smith researched the regulatory history they might however have realized that they had not obtained sufficient information from Alberta in the past and, in particular, they had not been given copies of any of the Alberta Audit Section reports.

Mr. Ross made a decision to permit the companies to continue selling, even though they were unregistered and despite the fact that they had failed to meet the July 31, 1986, deadline for an injection of capital which he had imposed upon them. This is significant given that at least $12 million worth of investment contracts were sold by the companies in B.C. during this five-month unregistered period. He accepted the proffered injection of assets without conducting any review of it himself and apparently without discussing it with Mr. Smith to ensure that an appropriate review had been conducted to determine whether the assets were qualified. Although it was critical to monitor the situation very closely after the claimed capital injection, Mr. Ross did nothing further at all until the September quarterly statements came in and were reviewed by Mr. Smith on November 5, 1986. His response after that point was to continue to rely on Alberta for a comprehensive review of the situation.

The Final Months: David Sinclair

David Sinclair was brought in on a temporary basis to deal with the crisis in management at the Office of the Superintendent of Brokers occasioned by Mr. Ross's departure. It was Mr. Sinclair who took the steps necessary to force the operations of AIC and FIC to a close.

Mr. Sinclair's brief superintendency was noteworthy for several outstanding characteristics. First of all, he was quick to anticipate problems, including the renewal date for the registration of the companies. In advance, he sought a legal opinion on his options with respect to renewal, and in making his decision to permit registration of AIC, he gave appropriate

weight to the various competing interests. While he knew that new investors were continuing to buy and should not be sacrificed, he also knew that he urgently needed more information before he could take the final step.

While in wanting more information Mr. Sinclair was not unlike the other regulators we have considered, the difference is that he took steps to pressure Alberta very hard to meet its responsibilities. He and Mr. Smith developed strategies to force Alberta both to provide the information British Columbia needed and to keep up the pressure in order to ensure that they received maximum co-operation. Mr. Sinclair stated that he was told by Alberta regulator Mr. Kalke on February 27, 1987, that the independent consultant's report was unfinished. However, he threatened to send Mr. Smith to Alberta to review the draft, which as a result, pressured Alberta into providing B.C. with a copy of the report. Mr. Sinclair noted the date on it was February 20, 1987. He concluded Mr. Kalke had not "levelled" with him.

He evidently had no doubts about the power of the statute to deal with the situation. He fully briefed the minister about the problems, he met with company officials and regulators in Alberta whenever it seemed necessary, and he prepared, in advance, the groundwork for several alternative courses of action. It was not until he left that it became clear that the government of Alberta would not bail the companies out, and so it fell to Mr. de Gelder to bring the crisis to its resolution.

Over three years from the date Mr. Jewitt first identified the potential $20 million shortfall, the companies were finally closed down. At that point, estimates showed total deficiencies to exceed $150 million.

Recommendation

The failure by successive Superintendents of Brokers to come to grips with the *Investment Contract Act* and the duties and powers prescribed by it led to a complete regulatory breakdown by the late 1970s. The companies drifted essentially unregulated into the mid 1980s, at which point, until the appearance of Mr. Sinclair in 1987, such regulation as did occur was inadequate and ineffective.

This report has identified longstanding and significant administrative negligence of the Office of the B.C. Superintendent of Brokers in failing to fulfil its statutory responsibilities in the regulation of AIC and FIC. This negligence enabled both companies to operate in a manner that was contrary to law and the public interest and directly resulted in the loss of investors' capital and interest.

While the administrative negligence of B.C. regulators was a major contributing cause of the B.C. investment contract holders' losses, it is not the only cause. Alberta government officials deliberately declined to act on clear evidence of the insolvency of AIC and FIC in 1984, and failed to advise B.C. regulators of this evidence. The Alberta government has accepted a measure of responsibility to B.C. investors by extending to them its compensation offer of ensuring 75% recovery to them. As identified in

the Code Report, corporate officials of AIC and FIC did not act in the best interests of investment contract holders, failed to deal with the impact of the real estate collapse and were a direct cause of the losses. Finally, the investment contracts could not have been totally secure investments, even if the companies had been perfectly regulated, because government regulators could not have been reasonably expected to exercise total and immediate control over the companies. The quarterly review of financial statements, together with regulatory due process, created an unavoidable time lag during which some losses could occur before a responsible decision to cancel licences could be made.

However, given the extensive administrative negligence of public officials in B.C. identified in this report, it would be unconscionable for the B.C. government to attempt to evade its responsibilities by putting those affected to years of expensive and debilitating litigation against itself. The reality for many of the elderly investors is that they would not survive the process.

In all of these circumstances, it is recommended that the B.C. government meet its responsibility to B.C. investment contract holders by supplementing their recovery from asset liquidation and distribution such as to achieve an overall 90% recovery of losses of principal and interest to July 2, 1987. Given the conditions which Alberta has imposed on the acceptance of its offer to investors, the B.C. government should negotiate aggressively to achieve a significant contribution from Alberta to compensate for the consequences of its deliberate failure to keep B.C. officials properly advised. Further, it is recommended that the B.C. government assist the investors financially to pursue whatever legal recourse might be available against company officials or other parties in order that they might eventually recover 100% of their losses, as they deserve to do.

This recommended compensation and assistance should not be considered as an expensive precedent, because the situation is unique. Since the collapse of AIC and FIC, the *Investment Contract Act* has been repealed in B.C. and the many bureaucratic failures identified in this report are being or have already been addressed by the Superintendent of Brokers' office, the Ministry of Finance and Corporate Relations and the Securities Commission. However, the case should serve as a clear reminder to government that if it is to legislate to itself statutory responsibility, then it must protect the public from the harm caused by the administrative negligence of its officials in failing to fulfil that responsibility.

Endnotes

Overview

[1]*B.C.D.C. v. Friedmann* [1984] 2 S.C.R. 442

[2]*Towards a Modern Federal Administrative Law*, Law Reform Commission of Canada, 1987.

Chapter I

[1]Like its Alberta counterpart, the Act was entitled *Investment Contracts Act* at the time of its enactment in 1962. The "s" was dropped in 1979. For convenience' sake, we refer to the most recent spelling throughout the body of this report.

[2]"Report to the Minister In the Matter of the *Trade Practice Act*, R.S.B.C. 1979, c.406 and In the Matter of First Investors Corporation Ltd., Associated Investors of Canada Ltd., Principal Consultants Ltd., Principal Savings and Trust Company, and Principal Group Ltd." [hereafter the Robinson report], p. 2.

[3]*Ibid.*, p. 9.

[4]*Ibid.*, Table of Contents.

Chapter V

[1]Mr. Marlin at various times held various positions in the Principal Group of Companies, including the presidencies of AIC, FIC and PCL.

Appendices

Appendix 1

Table of Statutes Referred to in the Report

Bankruptcy Act, R.S.C. 1985, c.B-3.
Canadian and British Insurance Companies Act, R.S.C. 1985, c.I-12.
Commodity Contract Act, R.S.B.C. 1979, c.56
Companies Creditors Arrangement Act, R.S.C. 1985, c.C-36.
Investment Contract Act, R.S.B.C. 1979, c.207.
Investment Contracts Act, R.S.A. 1980, c.I-10.
Mortgage Brokers Act, R.S.B.C. 1979, c.283.
Ombudsman Act, R.S.B.C. 1979, c.306.
Real Estate Act, R.S.B.C. 1979, c.356.
Securities Act, S.B.C. 1985, c.83.
Statute Law (Amendment) Act, R.S.B.C. 1979, c.44.
Trade Practice Act, R.S.B.C. 1979, c.406.
Trust Company Act, R.S.B.C. 1979, c.412.

Appendix 2

Investment Contract Act and Regulations

INVESTMENT CONTRACT ACT

[Repealed 1987-59-11, not in force]

CHAPTER 207

Interpretation

1. In this Act

"commission" means the British Columbia Securities Commission established under the *Securities Act*;

"investment contract" means a contract, agreement, certificate, instrument or writing containing

(a) an undertaking by an issuer to pay the holder, his assignee, personal representative or other person a stated or determinable maturity value in cash or its equivalent on a fixed or determinable date; and

(b) optional settlement, cash surrender or loan values, before or after maturity, for which the consideration is a single sum, or payments made or to be made to the issuer periodically, according to a plan fixed by the contract, whether or not the holder may be entitled to share in the issuer's profits or earnings, or to receive additional credits or sums from the issuer,

but does not include a contract within the meaning of the *Insurance Act*;

"issuer" means a corporation that offers for sale, sells or enters into investment contracts of its own issue, but does not include an insurer within the meaning of the *Insurance Act* or an association under the *Savings and Loan Association Act*;

"qualified assets" means

(a) cash;

(b) first mortgages on improved land and first mortgages made under *The Dominion Housing Act, 1935* (Canada), *The National Housing Act, 1944* (Canada), the *National Housing Act* [R.S.C. 1952] or the *National Housing Act, 1954* (Canada);

(c) securities authorized for investment under the *Trustee Act* or under the *Canadian and British Insurance Companies Act* (Canada);

(d) land acquired under section 12; and

(e) investments or securities designated by regulation;

"registered" means registered under this Act;

"salesman" means a person employed, appointed or authorized by an issuer to sell investment contracts;

"superintendent" means the Superintendent of Brokers under the *Securities Act*.

1962-30-2; 1970-44-12; 1975-31-1; 1985-83-205, effective February 1, 1987 (B.C. Reg. 269/86).

Application

2. (1) This Act does not apply to a credit union.

(2) This Act does not affect the validity of any investment contract entered into before July 1, 1962.

1962-30-28(2),30; 1966-45-12.

Filing form of contract

3. (1) A copy of the form of an investment contract shall be filed with the superintendent before a person issues for sale, offers for sale or sells a contract, in that form.

(2) The superintendent shall accept a form tendered unless the sale of an investment contract in that form would tend to be a fraud on the buyer.

(3) An investment contract, the form of which has not been filed with the superintendent under this section, may be rescinded by the holder or his assignee or personal representative.

1962-30-3,25(3).

Who may issue, sell contracts

4. (1) No person shall issue for sale an investment contract unless he is registered as an issuer.

(2) No person shall offer for sale or sell an investment contract unless he is

(a) registered as an issuer;

(b) recorded by the superintendent as an executive officer of a registered issuer;

(c) registered as a salesman; or

(d) registered under the *Securities Act* as a broker, broker dealer, investment dealer, sub-broker dealer or as a salesman of a person registered under that Act other than as a security issuer.

1962-30-4.

Registration of issuer

5. (1) No corporation shall be registered as an issuer unless

(a) it has filed with the superintendent a certified or photostatic copy of its instrument of incorporation, a certified list of the names and addresses of its executive officers, a certified copy of its balance sheet at the close of its last completed fiscal year, its auditor's report on the balance sheet and a copy of each form of investment contract proposed to be issued by it for sale in the Province;

(b) at least $100,000 of its authorized capital stock has been subscribed and paid in, in cash, and the aggregate of its unimpaired paid in capital and its surplus is at least $200,000; and

(c) arrangements satisfactory to the superintendent have been made to deposit, with a savings institution, or other depositary in Canada, qualified assets valued under sections 22 and 23 at not less at any time than the amount for which the corporation, under its investment contracts, is liable at that time to pay in cash to the holders of outstanding contracts, or at a smaller amount believed by the superintendent appropriate.

(2) A further deposit is not required where the corporation's deposit under subsection (1) (c) is outside the Province but in Canada.

1962-30-5; 1973-152-9.

Registration of salesman

6. No person shall be registered as a salesman unless there has been filed with the superintendent a written notice from a registered issuer to the superintendent that the person has been employed, appointed or authorized to sell investment contracts issued by the issuer. Termination of the employment, appointment or authorization to sell operates as a suspension of the registration.

1962-30-6.

Application for registration

7. (1) An application for registration shall be made in writing to the superintendent in the form and with the fee fixed by regulation.

(2) An applicant for registration shall provide an address for service in the Province. A notice under this Act or regulations is sufficiently served if delivered to the latest address.

1962-30-7,8.

Renewal of registration

8. A registration and renewal of registration lapses on the last day of March. A registered issuer or salesman desiring renewal of registration shall, before March 22, apply for renewal in the form and with the fee prescribed.

1962-30-9.

Registration or renewal

9. The superintendent, where the application is made and fee paid in accordance with this Act, shall grant registration or renewal of registration

(a) to an issuer where the applicant is suitable for registration and the sale of investment contracts issued by it would not tend to be a fraud on buyers of the contracts; and

(b) to a salesman where the applicant is suitable for registration and the proposed registration is not objectionable.

1962-30-10; 1963-42-11.

Reserves

10. (1) A registered issuer shall at all times maintain reserves to pay its outstanding investment contracts that, together with all future payments to be received by the issuer on those contracts, or the portions of those future payments still to be applied to reserves, and with accumulations of interest at an assumed rate provided in the contracts, will attain the face or maturity value specified in the contracts when due, or the amount payable under the terms of the contracts, or shall maintain reserves of a smaller amount deemed appropriate by the superintendent.

(2) The reserves shall at no time be less than the amount for which the registered issuer, under its investment contracts, is liable to pay in cash to the holders of all its investment contracts then outstanding.

(3) The assumed rate of interest to be provided in an investment contract under subsection (1) shall not exceed a rate approved by the superintendent, who may approve different rates for different forms of contract.

1962-30-11.

Investment of funds

11. Subject to section 12, a registered issuer may invest the funds received from the sale of investment contracts for which reserves are required under section 10 only in investments in which a trustee may invest his funds under the *Trustee Act* or in investments in which a company registered under the *Canadian and British Insurance Companies Act* (Canada) may invest its funds.

1962-30-12.

Power to acquire land

12. (1) A registered issuer may acquire for its use land necessary to transact its business. A building on the land may be larger than is required for its business and it may lease part of the building not so required.

(2) A registered issuer may acquire land mortgaged to it in good faith by way of security and land acquired by foreclosure or in satisfaction of a debt. The issuer may dispose of the land and shall sell the last mentioned land within 7 years after it has been acquired.

1962-30-13.

Suspension or cancellation of registration

13. (1) The superintendent may suspend or cancel a registration on any ground that would justify refusal of registration or renewal.

(2) The superintendent may suspend or cancel the registration of an issuer where it appears from the statements and reports filed with him or from an inspection or valuation that the issuer will be unable to provide for the payment of its investment contracts at maturity.

1962-30-14.

Further application for registration

14. Notwithstanding any order of the superintendent, a further application may be made on new or other material or where it is clear that material circumstances have changed.

1962-30-15.

Reasons in writing

15. The superintendent shall, on request of the person involved, give reasons in writing where he

(a) refuses to accept for filing a copy of the form of an investment contract or to grant or renew registration; or

(b) suspends or cancels a registration.

1962-30-16.

Review of decision of superintendent

16. (1) The superintendent shall notify the commission of every decision he makes

(a) refusing registration or renewal of registration of any person under section 9,

(b) suspending or cancelling the registration of any person under section 13, and

(c) refusing to accept the form of investment contract tendered under section 3,

at the same time as he notifies the person directly affected by his decision.

(2) The commission may review a decision referred to in subsection (1) and where it intends to do so shall, within 30 days of the date of the decision, notify the superintendent and any person directly affected by the superintendent's decision of its intention.

(3) Except where otherwise expressly provided, any person directly affected by a decision of the superintendent may, by a notice in writing sent by registered mail to the commission within 30 days after the mailing of the notice of the decision to him by the superintendent, request and be entitled to a hearing and a review of the decision of the superintendent.

(4) On a hearing and review, the commission may confirm or vary the decision under review or make another decision it considers proper.

(5) The commission may grant a stay of the decision under review until disposition of the hearing and review.

(6) The superintendent is a party to a hearing and review under this section.

1985-83-206, effective February 1, 1987 (B.C. Reg. 269/86).

Appeal of decision of commission

16.1 (1) Any person directly affected by a decision of the commission may appeal to the Court of Appeal with leave of a justice of that court.

(2) The commission or the Court of Appeal may grant a stay of the decision appealed from until the disposition of the appeal.

(3) The secretary shall certify to the registrar of the Court of Appeal

(a) the decision that has been reviewed by the commission,

(b) the decision made by the commission, following the review, together with any statement of reasons for it,

(c) the record of the proceedings before the commission, and

(d) all written submissions to the commission or other material that is relevant to the appeal.

(4) Where an appeal is taken under this section, the Court of Appeal may direct the commission to make a decision or to perform an act that the commission is authorized and empowered to do.

(5) Notwithstanding an order of the Court of Appeal in a particular matter, the commission may make a further decision on new material or where there is a significant change in the circumstances, and that decision is also subject to this section.

1985-83-206, effective February 1, 1987 (B.C. Reg. 269/86).

Filing statements

17. (1) Not later than 60 days after each quarterly period ending March 31, June 30, September 30 and December 31, a registered issuer shall file with the superintendent an interim statement verified by the affidavit of 2 directors showing for the last day of the quarter

(a) the amount required by section 10 to be maintained as reserves;

(b) all qualified assets with the savings institution or other approved depositary and the value, when valued under sections 22 and 23, of those qualified assets as at that date; and

(c) whatever information the superintendent requires.

(2) Not later than 90 days after the end of its fiscal year, a registered issuer shall file with the superintendent a balance sheet and profit and loss statement for that year, certified and reported on by its auditor, and any other financial statements reasonably required by the superintendent.

(3) The market value of all securities at the date of the statement shall be noted on the balance sheet.

1962-30-18(1,2,3).

Auditor

18. The auditor of an issuer registered under this Act shall be a chartered accountant, certified general accountant or other person or firm acceptable to the superintendent.

1962-30-18(4).

Inspection

19. (1) The superintendent may at any time inspect the records of an issuer and of a salesman.

(2) On the inspection, the superintendent or his representative is entitled to access to all books of account, cash, securities, documents, bank accounts, vouchers, correspondence and records of every description of the issuer or salesman. A person shall not withhold, destroy, conceal or refuse to furnish information or a thing reasonably required for the inspection.

1962-30-19.

Advertising and forms

20. The superintendent may at any time require an issuer or salesman to submit for review circulars, pamphlets, specimen contracts, application forms or other documents used by the issuer or salesman in selling investment contracts.

1962-30-20.

Notice of change by issuer

21. A registered issuer shall notify the superintendent in writing of a change in its address for service or in its executive officers and the beginning and end of a salesman's employment, appointment or authorization.

1962-30-21.

Valuation of assets

22. In any statement or balance sheet to be filed with the superintendent under this Act, an issuer may value its assets as

(a) cash, in the amount in lawful money of Canada;

(b) first mortgages, in the amount of the balance of the principal sum secured together with unpaid interest accrued;

(c) bonds, debentures and other evidence of indebtedness having a fixed term and rate of interest that are not in default on principal or interest and which, in the opinion of the superintendent, are amply secured at par if so purchased, and if purchased above or below par, on the basis of the purchase price adjusted to bring the value to par at maturity and to yield meantime the effective rate of interest at which the purchase was made, but the purchase price shall in no case be taken at a higher figure than the actual market value at the time of purchase;

(d) bonds, debentures and other evidence of indebtedness having a fixed term and rate of interest which are in default on principal or interest or which, in the opinion of the superintendent, are not amply secured at the market value at the date of the statement;

(e) stocks, at the book value, not in excess of the cost to the issuer and in the aggregate not in excess of the aggregate market value at the date of the statement; and

(f) other securities, at the book value but not in excess of the aggregate market value at the date of the statement.

1962-30-22(1).

Valuation in special cases

23. Where an asset consists of securities the market value of which is unduly depressed and in respect of which companies registered under the *Canadian and British Insurance Companies Act* (Canada) have been authorized to use values in excess of the market values, those assets may, with the approval of the superintendent, be valued as authorized under that Act; but if it appears to the superintendent that the amount secured by mortgage on a parcel of land, with interest due and accrued, is greater than the value of the parcel or that the parcel is not sufficient for the loan and interest, he may procure an appraisal of the land. If from the appraised value it appears that the parcel is not adequate security for the loan and interest, the loan or mortgage shall be valued at an amount not to exceed the appraised value.

1962-30-22(2).

Extension of time

24. The superintendent may extend the time for the filing of a statement, balance sheet or other document or the making of an application for renewal of registration under this Act.

1962-30-23.

Exempted sales

25. This Act does not prevent the sale of an investment contract by or on behalf of the holder where the sale is not made in the course of continued and successive transactions of like character or by a person whose usual business is the issue or sale of investment contracts.

1962-30-24.

Offences

26. (1) A person who contravenes section 3 (1), 4 (1) or 4 (2) commits an offence and is liable on conviction to a fine of not more than $5,000.

(2) A person who contravenes any other provision of this Act commits an offence and is liable on conviction to a fine of nct more than $500.

(3) An issuer or salesman who induces, directly or indirectly, an insured person to surrender, or allow to lapse or be forfeited, for cash or other valuable consideration, a contract of life insurance in order to effect an investment contract with an issuer is guilty of an offence against this Act.

1962-30-25(1.2),29.

Limits on prosecution

27. Proceedings to recover the penalties provided in section 26 shall not be instituted

(a) without the written consent of the Minister of Consumer and Corporate Affairs; or
(b) more than 2 years after the offence is committed.

1962-30-26; 1977-75-11.

Issuer not investment company

28. An issuer is deemed not to be an investment company under the *Securities Act.*

1962-30-28(1).

Regulations

29. The Lieutenant Governor in Council may make regulations, including regulations

(a) prescribing the fees payable on applications for registration and renewals of registration;
(b) designating investments or securities as qualified assets; and
(c) prescribing the rules and procedures to be followed in any hearing required or permitted by this Act.

1962-30-27; 1985-83-207, effective February 1, 1987 (B.C. Reg. 269/86).

B.C. Reg. 112/62.

INVESTMENT CONTRACT ACT

REGULATION MADE BY ORDER IN COUNCIL NO. 1918, APPROVED AUGUST 6, 1962

Division (1).—Applicants for Registration

1.01 An applicant for registration as an issuer shall complete and execute Form 1.

1.02 An applicant for registration as a salesman shall complete and execute Form 2.

1.03 An applicant for renewal of registration as an issuer shall complete and execute Form 3.

1.04 An applicant for renewal of registration as a salesman shall complete and execute Form 4.

Division (2).—Fees

2.01 Subject to section 2.03, the following fees shall be paid to the Superintendent of Insurance:—

(*a*) For registration or renewal of registration as an issuer $100.00

(*b*) For registration or renewal of registration as a salesman 25.00

2.02 After the 1st of January the fees for the registration of an issuer or salesman for the period ending the 31st day of March following shall be one-half the fees set out in section 2.01.

2.03 Until the 1st day of April, 1963, section 2.01 does not apply to a person who was registered under the *Securities Act* on the 30th day of June, 1962.

PROVINCE OF BRITISH COLUMBIA

FORM 1

INVESTMENT CONTRACTS ACT

APPLICATION FOR REGISTRATION AS AN ISSUER

Date of Application .....

Application for registration under the *Investment Contracts Act* as an issuer is hereby made and the following statements of fact are made in respect thereto:

1. Name .....
   Address of head office .....
   .....
2. Address for service in British Columbia .....
   .....
3. Address of branch offices in British Columbia .....
   .....
4. (*a*) (i) The authorized capital of the applicant is $....., and is divided into..... shares of $..... each.
   (ii) The number of shares without nominal or par value authorized is .....
   (*b*) The subscribed capital is $.....
   (*c*) The paid up capital is (i) for cash $.....
   (ii) for consideration other than cash $ .....
5. The names and addresses of the executive officers are:
   .....
   (If space provided is insufficient, please use reverse side of form.)
6. Has the applicant been registered or licensed or is it now registered or licensed in any capacity in any other Province, State, or country? *(If affirmative, give particulars.)*
   .....
7. Has the applicant or any officer or director of the applicant been refused a licence or registration, or has any registration or licence been suspended or cancelled in any Province, State, or country? *(If affirmative, give particulars.)*
   .....
8. Has the applicant or any officer or director of the applicant been convicted of any criminal offence within the last ten years? *(If affirmative, give particulars.)*
   .....
9. Has a judgment been rendered against the applicant or any officer or director of the applicant in the last three years? *(If affirmative, give particulars.)*
   .....
10. The following documents accompany this application:—
    (*a*) A certified or photostatic copy of the Act, certificate of incorporation, Letters Patent, or other instrument of incorporation of applicant.
    (*b*) A certified copy of the balance-sheet of the applicant as at the close of its last completed fiscal year and its auditor's report thereon.
    (*c*) Copies of all forms of investment contracts proposed to be issued by the applicant for sale in the Province.

Dated at....., the.....day of....., 19.....

.....
(Name of Company.)

.....
(President.)

.....
(Secretary-Treasurer.)

STATUTORY DECLARATION

CANADA: PROVINCE OF BRITISH COLUMBIA. TO WIT:	IN THE MATTER OF THE INVESTMENT CONTRACTS ACT

I, ...

of the....., in the Province of British Columbia, make oath and say:—

(1) I am an official of the applicant herein for registration, and I signed the application.

(2) The statements made in the application are true in fact and substance, and I make this solemn declaration conscientiously believing it to be true, and knowing that it is of the same force and effect as if made under oath and by virtue of the *Canada Evidence Act*.

DECLARED before me at.....
this.....day of....., 19....

.....
A Notary Public in and for British Columbia, a Commissioner, etc.

B.C. Reg. 112/62.

PROVINCE OF BRITISH COLUMBIA

FORM 2

INVESTMENT CONTRACT ACT

APPLICATION FOR REGISTRATION AS SALESMAN

Application is made for registration under the *Investment Contract Act* as.....

and the following statements of fact are made in respect thereof:—

1. (*a*) Name of employer .....
   (*b*) Name of applicant in full .....
   (*c*) Place of residence ..... Tel. No.....
   (*d*) Business address, if registered .....
   ..... Tel. No.....
   (*e*) State address for service in British Columbia .....
   .....
2. (*a*) I have resided in British Columbia continuously for a period of.....
   (*b*) If applicant has not resided in British Columbia for at least one year immediately prior to the date of this application, with the intention of making his permanent home in British Columbia, give particulars including address where he lived.
3. The following information constitutes full disclosure of the business activities and residences of the applicant for the full fifteen-year period immediately preceding the date of application including periods when unemployed:

Name and Address of Employer or Place of Activities when Unemployed	Nature of Business of Employer	Nature of Employment or Activity	Period of Employment or Activity From: To:	Residence during the Period Was (City, street, and number.)

(If further space required, turn over leaf.)

4. Will you be engaged or employed in any business or occupation other than selling investment contracts?
5. Has the applicant been charged, indicted, or convicted under any law of any Province, State, or country, or been named in any injunction in connection with proceedings taken on account of fraud arising out of any trade in any investment contract or security, or are there any proceedings now pending which may lead to an indictment, conviction, or injunction? *(Answer "Yes" or "No." If affirmative, give particulars.)*
6. Has judgment been rendered against the applicant in any civil court for damages arising from fraud? *(Answer "Yes" or "No." If affirmative, give particulars.)*
7. Has the applicant ever been discharged by any employer for any cause involving fraud in connection with a trade in any investment contract or security, or for any criminal offence? *(Answer "Yes" or "No." If affirmative, give particulars.)*
8. Has the applicant at any time been declared bankrupt or made a voluntary assignment in bankruptcy? *(Answer "Yes" or "No." If affirmative, give particulars.)*
9. Has the applicant heretofore been licensed, or registered, to sell securities, insurance, or investment contracts in British Columbia, or any other Province, State, or country? *(Answer "Yes" or "No." If affirmative, give particulars.)*

B.C. Reg. 112/62.

10. (*a*) Has the applicant been refused a licence, or registration, to sell investment contracts, securities, or insurance in British Columbia, or any other Province, State or country? *(Answer "Yes" or "No." If affirmative, give particulars.)*
    (*b*) Has any licence, or registration, to sell investment contracts, securities, or insurance of the applicant been suspended or cancelled? *(Answer "Yes" or "No." If affirmative, give particulars.)*
11. Has the applicant ever used, operated under, or carried on business under any name other than the name hereto subscribed as applicant? *(Answer "Yes" or "No." If affirmative, give particulars.)*
12. To each of the following named persons the business reputation of the applicant is well known and reference may be made to them for further information *(give at least five names, including one bank reference)*:—

NAME	P.O. ADDRESS (Give city and street address.)	BUSINESS OR OCCUPATION

13. The following is a detailed description of the applicant:
    Age..... Height..... Weight..... Complexion .....
    Colour hair..... Colour eyes..... Moustache.....
    Male or female..... Nationality..... Married or single.....
    Municipality, Province, State, etc., of birth .....
    Distinguishing marks .....

Dated at .....
this.....day of....., 19....

.....
Signature of applicant.

AFFIDAVIT

CANADA:
PROVINCE OF BRITISH COLUMBIA.
TO WIT:

IN THE MATTER OF THE INVESTMENT CONTRACTS ACT

I, ...
(Name in full.)
of the ....., in the Province of .....
make oath and say:—

(1) I am....., the applicant
(Name in full.)
herein for registration, and I signed the application.

(2) The statements of fact made by me in the application are true.

SWORN before me at the.....
in the Province of.....
this.....day of....., 19....

.....
A Notary Public in and for British Columbia, a Commissioner, etc.

B.C. Reg. 112/62.

CERTIFICATE OF INTENDED EMPLOYER

To the Superintendent of Insurance:

I have made inquiries from the applicant and from persons acquainted with the applicant, and from reports received as to his ability and his integrity, I believe that he is suitable for registration. The information submitted by the applicant in the foregoing application is, to the best of my information and belief, true and correct; and I request that the application be granted.

Dated ....., 19....

.....
(Employer.)

By.....

.....
(Title of official signing.)

.....
(Address of employer.)

PROVINCE OF BRITISH COLUMBIA

FORM 3

INVESTMENT CONTRACT ACT

APPLICATION FOR RENEWAL OF REGISTRATION AS AN ISSUER

Date of Application ....., 19....

Application for renewal of registration under the *Investment Contract Act* as an issuer is hereby made and the following statements of fact are made in respect thereto;—

(1) Name .....

Address of head office .....

.....

(2) Address for service in British Columbia .....

.....

(3) Address of branch offices in British Columbia .....

.....

(4) State value of the assets of the applicant at the close of the last completed fiscal year

.....

(5) Has there been any material change in the company during the preceding year, such as alteration in the capital structure of the company, change in ownership or control of the company, change in Directors, etc. *(if so, give particulars)* .....

.....

DATED at ..... this ..... day of ....., 19....

.....
(Name of company.)

.....
(President.)

.....
(Secretary-Treasurer.)

B.C. Reg. 112/62.

PROVINCE OF BRITISH COLUMBIA

FORM 4

INVESTMENT CONTRACTS ACT

APPLICATION FOR RENEWAL OF REGISTRATION AS A SALESMAN

Date of Application ....., 19....

The undersigned hereby applies under the *Investment Contracts Act* for a renewal of registration as a salesman for .....
(Registered issuer.)
and the following statements of fact are made in support thereof:—

(1) My present business address .....

.....

(2) My address for service in British Columbia .....

.....

(3) Statement of any change in the facts as set out in my application for registration as a salesman .....

(4) Will you be engaged in or employed in any business or occupation other than selling investment contracts? .....

DATED at ..... this ..... day of ....., 19....

.....
(Signature of Applicant.)

CERTIFICATE OF REGISTERED ISSUER

To the Superintendent of Insurance:

I certify that .....
(Name of applicant for registration.)
is employed, appointed, or authorized to sell investment contracts issued by this Company. The information submitted by the applicant in the foregoing application is, to the best of my information, true and correct, and I request that the application be granted.

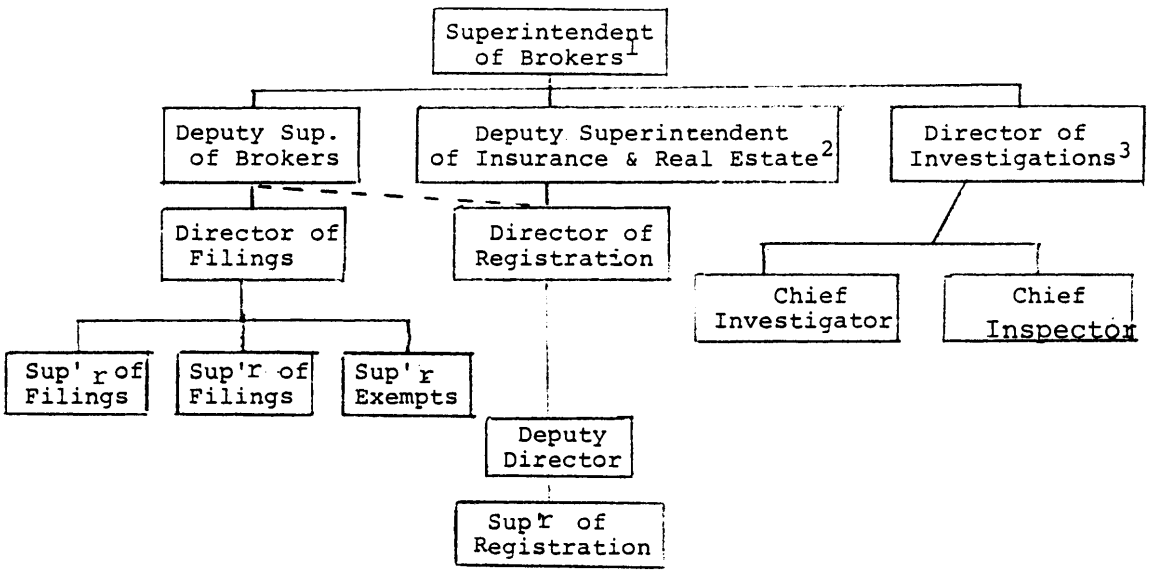
.....
(Name of registered issuer.)

.....
(Title of official signing.)

.....
(Address of employer.)

Appendix 3

Organizational Structure: Office of the Superintendent of Brokers, 1982–85



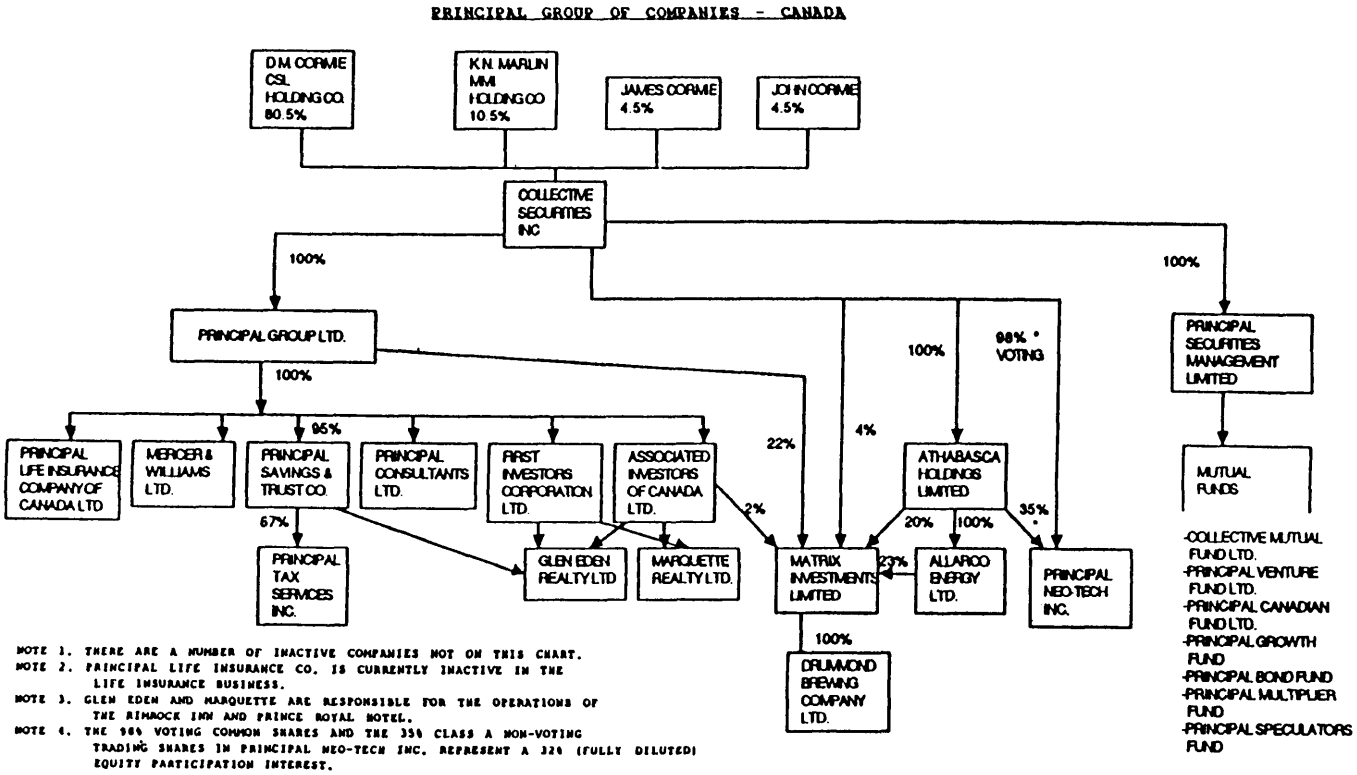
1. Prior to 1976 the Office of the Superintendent of Brokers was in the Ministry of the Attorney General. From late 1976 to late 1986 it was in the Ministry of Consumer and Corporate Affairs. The Superintendent of Brokers reported to the Assistant Deputy Minister of Corporate Affairs. On November 6, 1986, the Superintendent of Brokers was transferred to the new Ministry of Finance and Corporate Relations, and the Superintendent reported to the Assistant Deputy Minister of Corporate Relations until the B.C. Securities Commission came into being in February 1987, after which time the Superintendent of Brokers reported to its chairman.

2. On January 12, 1978, the Superintendent of Brokers took on the responsibility for insurance and real estate. Responsibility for insurance was later transferred to the Superintendent of Credit Unions, Co-operatives and Trust Companies in April 1986. Real estate was transferred to the Superintendant of Financial Institutions in 1987. Between 1978 and 1987 it was the general view that the Registration Department reported to the Deputy Director of Insurance and Real Estate, although there existed "parallel" reporting to the Deputy Superintendent of Brokers on matters relating to the securities side (including investment contract companies).

3. Between 1974 and 1978 the Director - known as "Chief Investigator" - reported to the Deputy Superintendent of Brokers in Vancouver. Between 1978 and 1985 the Chief Investigator, later referred to as the Director of Investigations, reported directly to the Superintendnt of Brokers. After April 1, 1985, the Director reported directly to the Assistant Deputy Minister of Corporate Affairs.

Appendix 4

Organizational Structure: Principal Group of Companies, December 1986



Appendix 5

Table of Registration History for AIC: 1963 to 1987[1]

Reg'n Year[2]	Ren. Appr. Rec'd[3]	Ren. Cert. Dated[4]	Ren. Approved[5]	Comments
1963-1964				
1964-1965				
1965-1966				
1966-1967				
1967-1968				
1968-1969				
1969-1970				
1970-1971*				The document bears no "typing" date though it was signed by E.T. Cantell indicating that it was effective from March 1, 1970.
1971-1972*				This document bears no "typing" date though it was signed by W.S. Irwin as being effective from April 1, 1971.
1972-1973*	Mar. 16, 1972	Mar. 23, 1972		
1973-1974*	Mar. 15, 1973			On March 26, 1973 AIC formally withdrew its application for renewal.
1974-1975				
1975-1976				
1976-1977				
1977-1978*	July 4, 1977	Jan. 26, 1978		
1978-1979*	May 2, 1978	May 5, 1978		
1979-1980*	Mar. 15, 1979	Mar. 22, 1979		
1980-1981*	Mar. 11, 1980	Mar. 26, 1980		
1981-1982*		Mar. 23, 1981		
1982-1983*	Mar. 19, 1982	Mar. 31, 1982		
1983-1984	Mar. 21, 1983	Mar. 29, 1983		No approval indicated
1984-1985	Mar. 20, 1984	Mar. 21, 1984	Mar. 21	1st year Uniform Application used (contrary to Reg's)
1985-1986	Mar. 14, 1985	Mar. 18, 1985	Mar. 18	
1986-1987	Mar. 24, 1986	Aug. 28, 1986	Aug. 27	
1987-1988	Apr. 6, 1987	Apr. 8, 1987	Apr. 7	

Notes:

1. The information in this section comes either from documents provided by the Superintendent of Brokers' office or from the Trustee in Bankruptcy for AIC, in which case it is marked "*".
2. AIC was incorporated May 3, 1948 and initially registered June 19, 1950 in B.C. The original *Investment Contracts Act* came into force on July 1, 1962; accordingly, the first registration pursuant to the Act would have been for the period of April 1, 1963—March 31, 1964.
3. Applications to renew were required by the Act to be made prior to March 22. Documents received from the Trustee in Bankruptcy for AIC show the date the application was *made* rather than the date it was received.
4. The date the registration certificate was prepared does not necessarily indicate the date it was sent to the registrant, although every registration issued for AIC was effective from April 1 to March 31, except for January 26—March 31, 1978.
5. Not all renewals bear an indication that they were approved.

Appendix 6

Table of Registration History for FIC: 1963 to 1987[1]

Reg'n Year[2]	Ren. Appr. Rec'd[3]	Ren. Cert. Dated[4]	Ren. Approved[5]	Comments
1963-1964	Mar. 20, 1963	Mar. 27, 1963		List of salesmen appended
1964-1965	Mar. 16, 1964	Mar. 31, 1964		List of salesmen appended
1965-1966	Mar. 24, 1965	Mar. 31, 1965		List of salesmen appended
1966-1967	Mar. 17, 1966	Apr. 5, 1966		
1967-1968	Mar. 9, 1967	Apr. 12, 1967		
1968-1969	Mar. 21, 1968	Mar. 26, 1968		
1969-1970	Mar. 19, 1969	Mar. 24, 1969		
1970-1971	Mar. 10, 1970	Apr. 1, 1970		
1971-1972	Mar. 19, 1971	Mar. 19, 1971		
1972-1973	Mar. 23, 1972	Mar. 23, 1972		
1973-1974	Mar. 19, 1973	Mar. 20, 1973	Mar. 20	Certificate issued by Supt. of Insurance[6]
1974-1975*	Mar. 10, 1974	Mar. 19, 1974	Apr. 25	Application is dated March 15.
1975-1976	Mar. 6, 1975	Mar. 6, 1975		
1976-1977	Mar. 18, 1976	Mar. 18, 1976		
1977-1978	Mar. 22, 1977	Mar. 23, 1977	Apr. 5	
1978-1979	Mar. 22, 1978	Mar. 22, 1978		
1979-1980	Mar. 21, 1979	Mar. 22, 1979		
1980-1981	Mar. 25, 1980	Mar. 26, 1980		
1981-1982	Mar. 20, 1981	Mar. 20, 1981		
1982-1983	Mar. 24, 1982	Mar. 31, 1982		1st computerized certificate
1983-1984	Mar. 21, 1983	Mar. 29, 1983		
1984-1985	Mar. 20, 1984	Mar. 21, 1984	Mar. 21	1st year Uniform Application used (contrary to Reg's)
1985-1986	Mar. 14, 1985	Mar. 18, 1985	Mar. 18	
1986-1987	Mar. 24, 1986	Aug. 28, 1986		
1987-1988	Feb. 26, 1987	Mar. 19, 1987		

Notes:

1. The information in this section comes solely from documents provided by the Superintendent of Brokers' office.
2. FIC was incorporated February 3, 1954 as "Bankers Investment Corp. Ltd" changing its name on September 28, 1954 to "FIC". It became registered in B.C. on October 14, 1954. The original *Investment Contracts Act* came into force on July 1, 1962; accordingly, the first registration pursuant to the *Act* would have been for the period of April 1, 1963—March 31, 1964.
3. Applications to renew were required by the Act to be made prior to March 22.
4. The date the registration certificate was prepared does not necessarily indicate the date it was sent to the registrant, although every registration issued for FIC was effective from April 1 to March 31.
5. Not all renewals bear an indication that they were approved.
6. From this year until the 1981 certificate, all bore the imprint "Superintendent of Insurance".

* A meeting was held at the Offices of the B.C.S.C. on April 18, 1974 between FIC officials and the Superintendent of Brokers' staff. The conditions imposed were met by April 25, 1974 and registration was issued 25 days late. The registration certificate was mailed to FIC on May 9, 1974.

Appendix 7

Table of Financial Filings for FIC and AIC: 1963 to 1987[1]

	Date Rec'd	Kind	In[2]	Comments
1963:	March			
	June			
	Sept.			
	Dec.			
	Dec. 31 annuals			
1964:	March			
	June			
	Sept.			
	Dec.			
	Dec. 31 annuals			
1965:	March			
	June			
	Sept.			
	Dec.			
	Dec. 31 annuals			
1966:	March			
	June			
	Sept.			
	Dec.			
	Dec. 31 annuals			
1967:	March			
	June			
	Sept.			
	Dec.			
	Dec. 31 annuals			
1968:	March			
	June			
	Sept.			
	Dec.			
	Dec. 31 annuals			
1969:	March			
	June			
	Sept.			
	Dec.			
	Dec. 31 annuals			
1970:	March			
	June			
	Sept. *			Referred to in a letter from L.G.S. to B.O.A. & in a letter from L.G.S. to J.D. on Feb. 2, 1971.
	Dec.			
	Dec. 31 annuals *			Referred to in a letter from D.H. & S. to L.G.S. on June 28, 1971.

		Date Rec'd	Kind	In[2]	Comments
1971:	March				
	June				
	Sept. *				Referred to in a letter from W.S.I to B.O.A. on Mar. 6, 1972.
	Dec. *				Referred to in letters from B.O.A. to W.S.I. on March 17, 1972.
	Dec. 31 annuals				
1972:	March				
	June *				Referred to in report of L.G.S. to W.S.I. on Oct. 18, 1972.
	Sept.				
	Dec. *				L.G.S. writes "check & file" on covering letter of Mar. 16.
	Dec. 31 annuals *				Referred to in letter from E.F.S. to D.H. & S. on Dec. 13, 1973.
1973:	March *				Referred to in letter from E.F.S. to D.H. & S. on Dec. 13, 1973.
	June *				Referred to in letter from E.F.S. to D.H. & S. on Dec. 13, 1973.
	Sept. *				Referred to in letter from E.F.S. to D.H. & S. on Dec. 13, 1973.
	Dec.				
	Dec. 31 annuals*				Referred to in letter from W.S.I. to K.N.M. on Mar. 22, 1974.
1974:	March				
	June *				Referred to in letter from W.S.I. to K.N.M. on Sept. 6, 1974.
	Sept.				
	Dec.				
	Dec. 31 annuals				
1975:	March				
	June				
	Sept.				
	Dec.				
	Dec. 31 annuals				
1976:	March				
	June				
	Sept.				
	Dec.				
	Dec. 31 annuals				
1977:	March		Aud-Compliance	X	(Only FIC)
	June		Aud-Compliance	X	(Only FIC)
	Sept.			X	(Only FIC)
	Dec.				
	Dec. 31 annuals		Aud-Conventional	X	(Only FIC)
1978:	March		Aud-Compliance	X	(Only FIC)
	June		Aud-Compliance	X	(Only FIC)
	Sept.		Unaud-Compliance	X	(Only FIC) E.T.J. writes "tape" on Nov. 10, 1978 (Only FIC)
	Dec.	Mar. 9/79	Aud-Compliance	X	Rec'd 9 days late. E.T.J. writes "acknowledge" on Mar. 12/79. (Only FIC)
	Dec. 31 annuals				

		Date Rec'd	Kind	In[2]	Comments
1979:	March				
	June				
	Sept.				
	Dec.				
	Dec. 31 annuals				
1980:	March				
	June				
	Sept.				
	Dec.				
	Dec. 31 annuals				
1981:	March				
	June				
	Sept.				
	Dec.				
	Dec. 31 annuals				
1982:	March				
	June				
	Sept.				
	Dec.				
	Dec. 31 annuals				
1983:	March				
	June				
	Sept.				
	Dec.				
	Dec. 31 annuals	May 16/84	Aud-Conventional	X	Rec'd 36 days late. Warning letter sent May 1/84.
1984:	March	June 16/84	Unaud-Compliance	X	Rec'd 17 days late. Warning letter sent June 1/84.
	June	Aug. 17/84	Unaud-Compliance	X	E.T.J. writes "file" on Aug. 21/84 (FIC) and on Aug. 22/84 (AIC)
	Sept.	Oct. 26/84	Unaud-Compliance	X	E.T.J. writes "file" on Nov. 15/84 (AIC)
	Dec.				Never sent.
	Dec 31 annuals	Feb. 20/85	Aud-Conventional	X	Sent twice—a 2nd time on Mar. 13/85
1985:	March	Aug. 15/85	Unaud-Compliance	X	Sent twice—76 days late.[3]
	June	Aug. 15/85	Unaud-Compliance	X	Sent twice (FIC)
	Sept.	Apr. 8/86		X	130 days late. Only 2 pages—no compliance statements.
	Dec.		Aud-Compliance	X	Arrived June 10/86—102 days late.
	Dec. 31 annuals	June 9/86	Aud-Conventional	X	Rec'd 70 days late.
1986:	March	June 20/86	Unaud-Compliance	X	21 days late.
	June	July 30/86	Unaud-Compliance	X	
	Sept.	Oct. 30/86	Unaud-Compliance	X	
	Dec.	Jan. 21/87	Unaud-Compliance	X	
	Dec 31 annuals	Jan. 21/87	Aud-Conventional	X	Only a draft.
1987:	March				Never sent.

Notes:

1. All documents listed came from the Office of the Superintendent of Brokers unless marked "*", in which case they came from the Government of Alberta.
2. An "X" indicates that the financial statements were in B.C. files.
3. For the March, 1985 quarterly statements for AIC the inserted "compliance" sheet is dated "1984" rather than "1985". It is, however, different than the one inserted in the March, 1984 statements.

Appendix 8

Chronology of Significant Events in the Regulation of AIC and FIC, 1962–87

The following list of events has been compiled from documents obtained during our investigation and from testimony provided to the Office of the Ombudsman during examination under oath of witnesses.

1962

Jul 1 — The British Columbia *Investment Contract Act* came into force. Responsibility for its enforcement was assigned to the Superintendent of Insurance. AIC and FIC, both incorporated in Alberta, had been extra-provincially registered under the *Companies Act* in B.C. since 1950 and 1954 respectively.

1966

May 24 — Principal Savings & Trust Company Ltd. (PS&T) was registered in B.C.

Sep 1 — Earl Jewitt joined the Office of the Superintendent of Brokers as chief accountant.

1967

Jan 3 — Principal Group Ltd. (PGL) was registered in B.C.

Oct — L.G. Smallacombe was hired by the Superintendent of Brokers as an accountant.

1969

The Report of the Canadian Committee on Mutual Funds and Investment Contracts identified significant risks to investors created by the selling tactics and investment strategies employed by investment contract companies.

Aug — Superintendent Irwin wrote to the Chairman of the Alberta Securities Commission to express his concern that the Principal Group was running advertisements saying that PS&T products could be purchased from FIC sales staff.

Sep — E.F. (Bill) Smith was hired by the Superintendent of Brokers as an accountant.

1970

Jan The Inspector of Trust Companies informed PS&T that it was illegal for FIC sales staff to sell PS&T products and demanded an end to the practice. PS&T agreed to comply with his demand and to instruct its sales staff accordingly.

Apr 3 Responsibility for enforcement of the B.C. *Investment Contract Act* was transferred to the Superintendent of Brokers, at that time W.S. Irwin.

May Concerned about apparent resemblances between the Principal Group and the Commonwealth conglomerate, which had recently become insolvent, Mr. Irwin wrote to the Alberta regulators asking whether they had sufficient information to determine to what extent the companies were leaning upon one another. The Chairman of the Alberta Securities Commission told him he had long felt "spooky" about investment contract companies controlled by the Principal Group.

Dec 4 Principal Consultants Ltd. (PCL) was incorporated in Alberta.

1971

Feb-Apr B.C. and Alberta regulators corresponded about their concerns that AIC and FIC appeared to be using above-market values in the valuation of their assets and to be engaging in non-arm's-length transactions with other companies in the Principal Group. B.C. regulators demanded detailed information from AIC and FIC and Mr. Smallacombe travelled to Edmonton to join the Alberta regulators in meeting representatives of the companies to discuss concerns about their financial condition.

Jun 11 An independent auditor's report (the Burton report) commissioned by the Alberta Securities Commission concluded, among other significant findings, that inter-company transactions in the Principal Group had the effect of splintering and thereby diminishing regulatory control. As well, it noted the risks posed by the companies' tendencies to concentrate on "the gambling type of assets".

Jul 15 PCL was registered in B.C.

1972

Mar 6 Superintendent Irwin invited AIC and FIC to show cause why their registrations should not be suspended, following the discovery that the companies' September 1971 quarterly financial statements showed significant deficiencies in the nature and value of the qualified assets required by the *Investment Contract Act*.

Mar 23 The companies' registration renewal certificates were issued after they agreed to revise their methods of asset valuation.

Apr 25 Earl Jewitt, chief accountant in the Superintendent of Brokers' office, wrote to the Alberta regulators suggesting that AIC and FIC be required to pay for a third appraisal of their investments by an independent valuator acceptable to both provinces. Alberta agreed with the proposal. AIC was subsequently obliged to obtain and pay for an independent appraisal of a New Brunswick real estate investment. The appraiser found the property to have been substantially overvalued.

Jul 17 The first director of the Registration Department took office. The department had been recently created to process document filings and registrations of companies supervised by the Superintendent of Brokers' office.

Oct 18 Lloyd Smallacombe, an accountant in the Filings Department who worked on the AIC and FIC files, noted in a written report to Mr. Irwin that the companies were "far from being solvent". He noted that the companies had overvalued questionable investments and that their parent companies had sold overvalued debentures to AIC and FIC in an effort to create qualified assets.

1973

Mar 9 Mr. Irwin wrote to AIC and FIC informing them thattheir registration renewals for 1973-74 would not be approved unless they rectified the deficiencies identified by Mr. Smallacombe. As a result, two weeks later, AIC withdrew its application for renewal of registration. It remained unregistered in B.C. until 1978.

Aug 31 The Superintendent of Brokers' office published a notice in the *Weekly Summary of Corporate, Financial and Regulatory Services* stating that the registrations of AIC and FIC as brokers in mutual funds had been discontinued.

1974

Jan 31 Bill Smith, an accountant who had joined Mr. Smallacombe in the monitoring of AIC and FIC, wrote to the president of FIC, Kenneth Marlin, demanding that a promissory note given to FIC by its parent company, PGL, be amended to include a "subrogation" clause that would require approval by the B.C. Securities Commission prior to its repayment. Mr. Smith had expressed concern that the purpose of the promissory note was to shore up the apparent value of FIC's qualified assets.

Mar 19 In a letter from Mr. Smith, Mr. Marlin was put on notice that the Superintendent of Brokers' office would not consider renewing FIC's registration until the company complied with his earlier request for the insertion of a subrogation clause into the note. The letter was copied to the Alberta regulators, who informed Mr.

Marlin that they also wanted to be a party to the subrogation clause demanded by B.C.

Mar 22 Mr. Irwin wrote to Mr. Marlin reiterating Mr. Smith's comments of January 31 and March 19.

Mar 26 Mr. Marlin wrote to Mr. Smith complying with the terms Mr. Smith had insisted upon.

Apr 25 Having received written assurance from Mr. Marlin that he would comply with Mr. Smith's terms, Mr. Smith instructed the Director of Registration to renew FIC's registration. The following day the Director approvedthe registration and backdated it to April 1, the date on which the company's registration had expired.

Sep 6 Mr. Irwin wrote to FIC demanding an immediate cash injection or else their continued registration would be in "immediate jeopardy".

1976

In conjunction with a departmental reorganization, the Superintendent of Brokers' office was transferred from the Ministry of the Attorney General to the Ministry of Consumer and Corporate Affairs.

1977

Jan A report by the Canadian Deposit Insurance Corporation expressed concern about the concentration of PS&T's assets in high-risk investments and about PGL's practice of siphoning profits away from PS&T through administrative charges.

1978

Jan 26 AIC, which had been out of operation in B.C. since 1973, was again registered by the Superintendent of Brokers' office.

Jan The offices of the Superintendents of Brokers, Real Estate and Insurance were merged.

Feb Mr. Smallacombe, the accountant who had been primarily responsible for monitoring AIC and FIC, went on long-term leave, and thereafter retired.

Sep The merged offices were transferred to Vancouver from Victoria.

PCL president Kenneth Marlin, in response to concerns raised by Alberta regulators, issued a directive to his sales staff instructing them to inform prospective investors that investment contracts were not covered by CDIC insurance.

Dec 21 The Deputy Superintendent of Trust Companies wrote to Mr. Marlin demanding that "bait and switch" tactics, in which investors

were lured by one company's investments but sold another's, cease on the premises of PS&T.

1979

Jan The Acting Deputy Superintendent of Trust Companies approved the sale of PS&T guaranteed investment certificates by PCL sales staff.

Summer A Project Definition Report prepared for the Superintendent of Brokers concluded that the efficiency of his office was hampered by staff shortages, inconsistent or non-existent policies and procedures, a poorly developed filing system, and inadequate checks that companies were meeting statutory filing requirements. The report's conclusions were later confirmed by an audit report prepared by the Comptroller-General.

Nov 2 The Superintendent of Credit Unions, Co-operatives and Trust Companies wrote to PGL to say that door signs on the premises of PS&T were misleading and to warn him not to allow his sales staff to misrepresent their products.

Nov 28 Mr. Irwin wrote to FIC to say that if the company continued to use bait-and-switch tactics he would make an order against it.

Dec 28 Earl Jewitt, the chief accountant in the Filings Department, was appointed Deputy Superintendent of Brokers.

1980

Jan Superintendent of Brokers W.S. Irwin resigned. He was replaced by Rupert Bullock.

Jun 26 A member of the Investigations Department noted in a memo to the chief investigator that he considered the manner in which the Principal Group operated to be a fraud upon the public. He objected to promotional material advertising "guaranteed" interest rates of 11 per cent.

1982

Jul 12 H.A. Dilworth took office in the newly created position of Director of Investigations.

Oct Mr. Dilworth issued a directive instructing his staff to provide to other departments in the Superintendent of Brokers' office any important information obtained during an investigation that might be of use to them. An earlier memorandum had instructed staff to direct all memoranda through him.

Nov 1 An accountant with the office of the Alberta Superintendent of Brokers submitted an annual review to his superiors indicating that AIC was in serious financial trouble.

1983

Mar 8 Mr. Dilworth issued a directive to his staff instructing them to channel through him any information to be sent outside the Investigations Department.

Apr 6 Mr. Jewitt refused to provide copies of forms of investment contracts filed with the office to a lawyer who asked to see them. Mr. Jewitt told us that he did not consider such forms to be "public information".

Sep 12 The Superintendent of Credit Unions, Co-operatives and Trust Companies wrote to John Cormie chastising him for the business practices of PS&T.

Oct 28 Superintendent Bullock wrote to Deputy Minister Edgar to advise him that the filing volume in the Superintendent of Brokers' office had multiplied by two and a half times in the past year and a half.

1984

Jan 12 The Alberta Superintendent of Insurance, Tewfik Saleh, wrote to the president of FIC, Mr. Marlin, to say that major deficiencies in qualified assets and reserves, together with the transfer of promissory notes between FIC and its parent company, represented a breach of the provisions of the Alberta *Investment Contracts Act* and were prejudicial to the interests of investment contract holders.

Jan Superintendent Bullock notified Mr. Edgar that the Superintendent of Brokers' office was finding it difficult to cope with a tremendous backlog of files created by staff vacancies and the recent public service strike.

Mar 24 PS&T sold certain mortgage interests to AIC and FIC at a price of $24 million. Auditors' notes indicated that the market value of the mortgages was only $18 million.

May 1 The Registration Department wrote to AIC and FIC to inform them that their financial statements were overdue. The companies responded by submitting their 1983 audited annual financial statements, but did not submit the quarterly statements.

May 11 The Alberta Superintendent of Insurance suggested to Mr. Marlin that he reverse a transaction in which AIC and FIC had paid $24 million for PS&T's interest in jointly owned mortgages and real estate. Thetransaction, he said, appeared to be prejudicial to the interests of investment contract holders. He demanded an immediate interim injection of $25 million into FIC and $10 million into AIC. The companies declined to comply with the demand.

May 29 Mr. Jewitt wrote to Mr. Saleh, the Alberta Superintendent of Insurance, to say that a preliminary analysis of AIC's and FIC's 1983 annual financial statements indicated a possible shortfall of $20

million. He added that he had discovered that there were no quarterly financial statements for either company since 1978 in the files of the Superintendent of Brokers' office. He asked Mr. Saleh to provide him with information with respect to Alberta's knowledge of the financial condition of the companies. In testimony to this office, Mr. Jewitt added that he also noted that the files contained no audited annual financial statements for this period.

May 29 Having received a copy of Mr. Jewitt's letter to Mr. Saleh, Mr. Dilworth forwarded it to a senior inspector in his department, who contacted Mr. Jewitt. Having been advised that the assistance of the Investigations Department was not required by Mr. Jewitt at that time, Mr. Dilworth marked the file to be brought forward in two months' time.

Jun 11 The Superintendent of Credit Unions, Co-operatives and Trust Companies wrote to the general manager of PS&T in Edmonton, suggesting that the company was practising bait-and-switch tactics.

Jul 3 Mr. Jewitt wrote to the Acting Director of Registration that, having spoken to the Deputy Superintendent Insurance of Alberta regarding AIC and FIC, he was anticipating receiving a report from Alberta within two weeks. Mr. Jewitt told us the report was never received.

Aug 13 Allan Hutchison, an auditor in the Office of the Alberta Superintendent of Insurance, reported to his superiors that, having examined FIC's financial statements as well as unaudited records, he had concluded that the company was insolvent. He submitted similar findings regarding AIC three days later. These reports, which were apparently those "anticipated" by Mr. Jewitt, were not forwarded to the B.C. regulators.

Aug 21 An inspector in the Investigations Department, who had been assigned the AIC and FIC file that had been brought forward as a result of Mr. Dilworth's action at the end of May, asked Mr. Jewitt for information and was told that a response from Alberta was being awaited. At Mr. Jewitt's suggestion, the junior inspector called Bernie Rodrigues, the Deputy Superintendent of Insurance in Alberta. Mr. Rodrigues told him that the companies, which were now required to submit monthly financial statements by Alberta, seemed to be showing a slight improvement in their profit picture, and that Alberta would keep B.C. updated on any new developments. The inspector reported his conversation with Mr. Rodrigues to Mr. Dilworth and Mr. Jewitt.

Sep 28 The inspector again called Mr. Rodrigues and was told that the companies' auditors were disputing the valuation methods proposed by the Alberta regulators and were asking that personal guarantees of shareholders be considered a permissible form of security. The inspector reported his conversation to Mr. Dilworth.

Oct 18 The Acting Deputy Director of Registration wrote to AIC and FIC asking the companies to submit their September 1984 quarterly financial statements if the companies wished to keep their registration in good standing. The statements were not due until the end of November.

Nov 27 The inspector in the Investigations Department wrote to Mr. Dilworth that he had called Mr. Saleh, the Alberta Superintendent of Insurance, who had told him that his office was in the process of determining how much capital needed to be injected into the companies so that they met the asset requirements of the *Investment Contracts Act*.

1985

Feb 6 The Registration Department wrote to AIC and FIC to demand their December 1984 quarterly financial statements, which were not due until the end of February.

Mar 5 The inspector reported to Mr. Dilworth that he had learned in a phone call with the Alberta regulatorsthat they had obtained an $11.3 million cash infusion and were continuing to monitor the companies closely.

Mar 15 Mr. Jewitt suggested to Superintendent Bullock that AIC and FIC be closely monitored. Mr. Jewitt wrote to the Director of Filings, Mr. Affleck, asking for his opinion on the companies' 1984 annual financial financial statements, which had recently been submitted. Mr. Affleck replied that he found the format of the statements to be "grossly" misleading and suggested they be forwarded to the Canadian Institute of Chartered Accountants for an opinion.

Mar 18 Registration renewal certificates for AIC and FIC were issued despite the fact that neither company had submitted its December 1984 quarterly financial statements. The statements were never submitted.

Apr 3 Mr. Jewitt wrote to Mr. Affleck stressing the need to continue monitoring AIC and FIC.

Apr The Investigations Department was moved out of the Superintendent of Brokers' office to assume an expanded role in the provision of services to all regulatory offices of the Ministry of Consumer and Corporate Affairs.

Jul 8 Mr. Affleck wrote to CICA asking it to provide an opinion on whether the format of the 1984 annual statements was suitable. Two weeks later, CICA replied without offering an opinion and suggesting that the regulators contact the auditors directly.

Jul 11 The registration clerk wrote to Mr. Jewitt asking him to make a notation on AIC's and FIC's December 1984 quarterly and 1984 annual financial statements if they were "okay for renewal". Mr.

Jewitt responded by indicating that the companies' registration renewals should be approved although he was not happy with the financial statements. Their registrations had been renewed three months earlier.

Aug 8 Mr. Affleck wrote to PGL questioning the presentation of AIC's and FIC's 1984 annual financial statements. Mr. Affleck received no written response and although telephone messages were exchanged no contact was ever made.

Aug 9 The inspector reported to Mr. Dilworth that Alberta seemed to think the companies' financial shape had improved but was continuing to monitor them closely. This was the final monitoring carried out by the Investigations Department.

Aug 15 The March and June quarterly financial statements were received after the Acting Director of Registration wrote to demand them on July 23.

Sep 18 The Registration Department wrote to FIC instructing the company to file its March and June quarterly financial statements, which had been received a month earlier. The company responded by submitting a second set. On October 1, Mr. Jewitt sent them to Mr. Affleck, the Director of Filings, saying they "do not look good" and asking for his comments.

Nov 20 Mr. Jewitt wrote to an investor who had expressed concern about a rumour that the Principal Group might "go down". He told the investor there was no guarantee that the qualified assets on deposit would bring in their book value if the company was forced to liquidate, and added that the company was registered in good standing in B.C.

Nov 21 Mr. Jewitt wrote to the Alberta Superintendent of Insurance that AIC's and FIC's financial statements appeared to indicate a worsening situation and that it appeared that the companies might not be meeting statutory requirements. He asked for information with respect to Alberta's perspective on the companies' condition, noting that he considered it important to make a decision soon about their future as sellers of investment contracts.

Dec 4 Mr. Rodrigues, of the Alberta Superintendent of Brokers' office, responded to Mr. Jewitt's letter, indicating that Alberta had concluded there was "statutory capital impairment" and that the companies would be required to rectify it. He suggested that Mr. Jewitt review the companies with respect to their compliance with the B.C. Act.

Dec 5 The financial clerk in the Registration Department contacted Mr. Jewitt with respect to AIC's and FIC's financial statements and was advised that "we have not yet approved the financials for renewal". Registration renewal certificates for both companies had been issued in March.

Dec 18 Mr. Jewitt wrote back to Mr. Rodrigues, saying that the section in the B.C. statute dealing with valuation of assets was "very weak indeed" and that the companies were probably well within B.C.'s statutory requirements.

Dec 30 Mr. Bullock noted that he had spoken to Mr. Jewitt, who reported that he had been in touch regularly with the Alberta Superintendent of Insurance and that he felt that the companies were complying with the B.C. Act. Mr. Jewitt also reported that the companies continued to have "financial problems".

1986

Jan 19 Rupert Bullock resigned from his position as Superintendent of Brokers. The following day Earl Jewitt was named Acting Superintendent pending the selection of a permanent appointee, and E.L. Affleck was appointed Acting Deputy Superintendent while retaining his position of Director of Filings.

Mar 24 AIC and FIC submitted applications for renewal of registration for 1986-87 without their 1985 audited annual financial statements having been filed.

Mar 31 FIC notified the Superintendent of Brokers that the 1985 audit was still in progress and would be completed within the next few weeks, at which time the 1985 annual financial statements would be forwarded.

Apr 1 AIC and FIC ceased to be registered in British Columbia as investment contract companies.

Apr 3 The Registration Department wrote to the companies to inform them that if their September 1985 quarterly statements and their 1985 annual statements were not received by April 21, action might be taken that would affect their continued registration with the Superintendent of Brokers' office.

Apr 7 The companies submitted their September 1985 quarterly financial statements but not their December 31, 1985, audited annual or unaudited quarterly financial statements.

Apr 30 Mr. Jewitt asked a lawyer in the Legal Services Branch of the Ministry of the Attorney General for an opinion regarding his regulatory options, given his concern about the companies' financial condition. In testimony to our office he stated that he did not know that the registrations had expired on April 1.

May 27 The lawyer wrote to Mr. Jewitt saying that she had been too busy to address his inquiry and would be unable to do so for a couple of weeks unless the matter was considered urgent.

May 31 Mr. Jewitt retired.

Jun 1 David Edgar, Assistant Deputy Minister of Consumer and Corporate Affairs, became Acting Superintendent of Brokers and E.F. (Bill) Smith was named Acting Deputy Superintendent.

Jun 9 The companies' 1985 audited annual financial statements were received accompanied by a letter stating that the companies would submit financial statements for the 5 month period ending May 31, 1986, rather than for the quarter ending March 31. A second set of statements was received on June 10.

Jun 10 The Legal Services Branch lawyer provided an opinion on the Superintendent's statutory powers to obtain information. She suggested the Superintendent obtain further financial information from the companies.

Jun 12 Having reviewed the annual financial statements of AIC and FIC, Mr. Smith reported to Mr. Edgar that he had identified a deficiency in qualified assets of $43,338,530 for FIC and $12,163,025 for AIC.

Jun 13 Mr. Edgar, Mr. Smith, Mr. Affleck and the Legal Services Branch lawyer met to discuss an appropriate course of action in dealing with FIC and AIC. Following the meeting, Mr. Edgar called a representative of AIC and FIC and asked that the companies voluntarily stop selling investment contracts. The companies apparently agreed.

Jun 16 Mr. Smith asked AIC and FIC in a letter presented at a meeting with Mr. Marlin to voluntarily cease selling investment contract until the companies' financial problems had been resolved. He asked Mr. Marlin and Bill Johnson, Vice President of Finance for PGL, to provide detailed financial information about AIC and FIC. Mr. Johnson provided most of the requested information a few days later.

Jun 23 Michael C. Ross was appointed Superintendent of Brokers.

Jul 2 Having reviewed the information provided by Mr. Johnson and other officials, Mr. Smith reported to Mr. Ross that he calculated a shortfall in qualified assets of $9,567,649 for FIC and $1,683,000 for AIC. He prepared for Mr. Ross's signature a letter to the companies demanding an insertion of qualified assets of those amounts by July 31. Mr. Ross signed and mailed the letter on July 4.

Jul 23 Having reviewed the companies' financial statements for the quarter ending March 31, 1986, Mr. Smith reported to Mr. Ross that he had identified substantial losses by both companies during the first three months of the year in addition to those he had identified for 1985.

Jul 31 Mr. Johnson hand-delivered to Mr. Smith a letter from Mr. Marlin asking for an extension of time in order to meet the British Columbia regulators' demands. He also offered Mr. Smith PGL financial statements to review in his presence. Mr. Smith declined. On this

day Mr. Smith's temporary appointment as Acting Deputy Superintendent of Brokers ended.

Aug 1 Mr. Smith wrote to Mr. Ross that he would not invest a penny of his own money in either AIC or FIC and that continued operation in the twilight zone of non-registration should cease.

Aug 14 Mr. Smith reported to Mr. Ross that he had spoken to Mr. Marlin and set specific terms with respect to the type of qualified assets that would be considered acceptable by the Superintendent of Brokers' office.

Aug 25 The Legal Services Branch lawyer wrote to Mr. Ross advising him that the sale of investment contracts by companies which were not registered was an offence under the *Investment Contract Act* and that failure to enforce the provisions of the Act in such circumstances could result in an action in negligence against the Superintendent of Brokers. She sent a copy to Mr. Smith. Both men indicated that they did not receive her memorandum until after accepting the companies' infusion of apparently qualified assets.

Aug 27 Mr. Marlin met with Mr. Smith and informed him that the required assets had been injected into AIC and FIC in the form of promissory notes secured by PGL mutual fund holdings.

Aug 28 Registration renewal certificates for AIC and FIC were issued and back-dated to April 1.

Aug 29 Mr. Affleck's temporary appointment as Acting DeputySuperintendent of Brokers was rescinded. Five days later G.D. Mulligan assumed a permanent appointment as Deputy Superintendent of Brokers.

Sep 9 An Alberta government auditor, in a memorandum analyzing the $11 million injection made by PGL, questioned the legitimacy of the promissory notes as qualified assets. Later in the month the Alberta regulators, having met to discuss their concerns about the injection of assets, contacted British Columbia to ask whether B.C. regulators had accepted the promissory notes. They were apparently informed by an unknown B.C. regulator that they had.

Nov 5 Mr. Smith wrote to Mr. Ross commenting that his review of the September 1986 quarterly financial statements for AIC and FIC indicated substantial losses for the first nine months of 1986 and led him to suggest that Mr. Ross should consider again withdrawing their registration. He further suggested that Mr. Ross take immediate action. Shortly afterwards, Mr. Ross telephoned Allister McPherson in Alberta to further discuss Alberta's appointment of an independent consultant.

1987

Jan 20 Mr. Ross declined the request by Mr. Johnson of PGL for a meeting to discuss the 1986 unaudited annual financial statements for AIC and FIC. Mr. Ross told Mr. Johnson that he considered such a meeting unnecessary as he was waiting for the report of the independent consultant appointed by Alberta.

Feb 2 Michael Ross resigned from his post as Superintendent of Brokers. Nine days later David Sinclair was appointed Acting Superintendent.

Feb 3 Mr. Smith wrote to the Director of Registration asking him to stop sending him financial statements for AIC and FIC as he was no longer involved in the monitoring of the companies' affairs.

Feb 20 An independent consultant's draft report commissioned by the Alberta regulators concluded that AIC and FIC were insolvent and recommended that the Alberta Superintendent of Insurance cancel or suspend their licences. This draft report was sent to Mr. Sinclair on March 16.

Mar 23 Mr. Sinclair received the draft suspension orders that he had asked the Legal Services Branch to prepare. He wrote to the Alberta regulators saying that he would renew the companies' registrations while keeping a close watch on them, and he also wrote to Hon. Mel Couvelier, Minister of Finance and Corporate Relations, informing him of the gravity of the matter and indicating that Alberta appeared to be on top of the situation.

Apr 6 Mr. Sinclair wrote to the Alberta regulators stating that decisive action must be taken without further delay.

Apr 27 At a meeting between Alberta and B.C regulators it was decided that a further capital injection of between $50 million and $60 million was required to restore AIC and FIC to an acceptable financial position.

May 7 At a meeting between regulators from both provinces and company officials, Principal Group representatives agreed to demands to prepare a proper business plan and to provide Mr. Sinclair with complete financial statements for all Principal Group companies.

May 21 The B.C. Superintendent of Financial Institutions recommended to Mr. Couvelier that the British Columbia government not bail out AIC and FIC.

Jun 1 Neil de Gelder took office as Superintendent of Brokers.

Jun 3 In a series of meetings in Edmonton, B.C. advised the Alberta regulators that it would not participate in a bail-out plan. At this meeting the companies also submitted eight "salvage scenarios" for consideration. These were rejected by the Alberta and British Columbia regulators.

Jun 4	A memorandum to Mr. Sinclair from his consultant suggested that AIC and FIC should improve their equity by "at least 130 million" by July 1.
Jun 8	Mr. Sinclair met with the Minister, Deputy Minister and Assistant Deputy Minister of Finance and Corporate Relations and recommended that British Columbia reject any requirements by Alberta for B.C. participation in the financing of a support package for the companies.
Jun 30	The government of Alberta revoked the licences of AIC and FIC.
Jul 2	The B.C. Superintendent of Brokers revoked the licences of AIC and FIC.