

SPECIAL REPORT NO. 17 February 1996
to
The Legislative Assembly of British Columbia

**REGULATION OF NEWPORT REALTY
INCORPORATED
BY THE SUPERINTENDENT OF
BROKERS**

Ombudsman
Province of British Columbia

Canadian Cataloguing in Publication Data

British Columbia. Office of the Ombudsman

Regulation of Newport Realty Incorporated by the
Superintendent of Brokers

(Special report no. 17 - February 1996 to the
Legislative Assembly of British Columbia)

ISBN 0-7726-2742-8

1. Newport Realty. 2. British Columbia. Financial
Institutions Commission. Superintendent. 3. Real
estate mortgage investment conduits - British Columbia.
4. Investments - Law and legislation - British
Columbia. I. Title. II. Series: British Columbia.
Office of the Ombudsman. Special report ... to the
Legislative Assembly of British Columbia ; no. 17.

JL429.5.I63B74 1996 354.7110082's C95-960490-1

Table of Contents

Regulation of Newport Realty Incorporated by the Superintendent of Brokers

Letter from the Ombudsman	i
1.0 Introduction	1
2.0 The Newport Group	2
3.0 The Investigations	5
3.1 The First Investigation: January, 1984	5
3.2 The Second Investigation: May, 1985	7
3.3 The Third Investigation: January, 1986	7
3.4 The Fourth Investigation: August, 1986	10
4.0 Analysis	12
4.1 Why were the full powers provided by the statutes not utilized?	13
4.1.1 Poor inter-office communication	13
4.1.2 Understaffing of regulators	14
4.1.3 Over-reliance by the regulators on the RCMP	14
4.1.4 Over-reliance by the Investigations Branch on the Deputy Superintendent's decision	15
5.0 Government as Regulator	16
6.0 Recommendations	18



OMBUDSMAN

Legislative Assembly
Province of British Columbia

Please respond to:
☐ 931 Fort Street
Victoria, British Columbia
V8V 3K3
FAX: (604) 387-0198

☐ Suite 200, 1111 Melville Street
Vancouver, British Columbia
V6E 3V6
FAX: (604) 660-1691

General Inquiries: (604) 387-5855
Toll Free: 1-800-567-3247
TDD: 1-800-667-1303

Open Letter from the Ombudsman February 1996

In 1987 a number of persons complained to the Office of the Ombudsman about the government regulation of Newport Realty Incorporated. Until February of 1987 mortgage brokers were regulated by the Superintendent of Brokers. After that time responsibility for that regulation was transferred to the Superintendent of Financial Institutions. The investors had invested money in mortgages sold by Newport Realty Incorporated and had lost their investments when the company went bankrupt. They blamed the Superintendent of Brokers because they maintained that his office had been aware for some time that Newport Realty Incorporated was in financial trouble and was operating illegally. They believed that the government had failed in its duty to protect the public and that the payment of compensation might be appropriate. As a result, my Office began an investigation into the role of government regulators who were charged with the responsibility of monitoring the business activities of Newport Realty Incorporated.

This report outlines my findings and the recommendations I made to government, along with the government's response to those recommendations. The delay in reporting to the Legislative Assembly is attributable to the time required since I became Ombudsman to negotiate some form of financial compensation to the investors who were affected by government's failure to act.

When a government chooses a mandate, enacts legislation that imposes responsibilities on itself, delegates those responsibilities to regulators, and then fails to appoint enough individuals to carry out the required tasks, it cannot excuse itself from its responsibilities. When there is serious wrongdoing and public risk, it is appropriate for government to accept ultimate responsibility if personnel are unable to fulfill the statutory responsibilities. In my view when a statutory responsibility is relaxed because of shortage of staff, the inadequate allocation of resources amounts to administrative negligence.

Yours very truly,

Dulcie McCallum
Ombudsman for the Province of B.C.

1.0 Introduction

In 1987 a number of persons complained to the Office of the Ombudsman about the government regulation of Newport Realty Incorporated. Until February of 1989 mortgage brokers were regulated by the Superintendent of Brokers. After that time responsibility for that regulation was transferred to the Superintendent of Financial Institutions. The investors had invested money in mortgages sold by Newport Realty Incorporated¹ and had lost their investments when the company went bankrupt. They blamed the Superintendent of Brokers because they maintained that his office had been aware for some time that Newport Realty Incorporated was in financial trouble and was operating illegally. They believed that the government had failed in its duty to protect the public and that the payment of compensation might be appropriate. As a result, my Office began an investigation into the role of government regulators who were charged with the responsibility of monitoring the business activities of Newport Realty Incorporated.

¹ There is no connection between the present companies called Newport Realty 1986) Ltd. and Newport Realty Property Management and the companies referred to in this Report.

2.0 The Newport Group

The "Newport Group" of companies consisted of Newport Realty Incorporated, Newport Capital Corporation, Monterey Homes (Vancouver) Ltd., Monterey Homes (Victoria) Ltd. and Monterey Homes Inc. Newport Realty Incorporated was a licensed real estate sales company. Its operations began in Victoria, and Newport Realty Incorporated later opened a second office in Vancouver. Newport Capital Corporation appeared to function as a real estate development company and the Monterey Homes companies built houses.

In order to engage lawfully in the business of mortgage brokering, a company or individual must be registered with the Registrar of Mortgage Brokers pursuant to the **Mortgage Brokers Act**. Real estate companies licensed under the **Real Estate Act** are, in addition, "deemed" to be registered as mortgage brokers under s.12(1) of the **Mortgage Brokers Act**. Within the Newport Group, only Newport Realty Incorporated was deemed to be registered under the **Mortgage Brokers Act** and therefore only Newport Realty Incorporated was legally entitled to engage in mortgage brokering. Newport Realty Incorporated presented investors with a scheme whereby it would advance funds to Newport Realty Incorporated for investment in fractional mortgages on residential properties. The fractional mortgage interest would be registered on the property title. Monthly interest payments would be issued to the investor by Newport Realty Incorporated. As it turned out, Newport Realty Incorporated did not "broker" between independent mortgagors and the investors. Virtually all of the investors' funds went directly to Newport Capital Corporation, which occasionally purchased properties and had houses built by one of the Monterey Homes companies. The scheme, once revealed, resembled more a building loan fund than a mortgage brokering operation. Frequently, the investors' funds were not applied to mortgages, or, if they were, the mortgages were not registered on properties. Also, when mortgages were registered, frequently they were placed on properties that were, or soon became, over-encumbered. Investors' funds were at far greater risk than they realized.

Newport Realty Incorporated and Newport Capital Corporation declared bankruptcy respectively on February 17 and 19, 1987. The Trustee in Bankruptcy of Newport Realty Incorporated and Newport Capital Corporation issued a condensed statement of affairs as of April 13, 1988. The statement showed assets for the two corporations of \$223,757.12 and liabilities of \$4,174,712.45, leaving a deficiency of \$3,950,955.33. The list of creditors showed three preferred creditors, one secured creditor, and 289 unsecured creditors. The investors were soon advised by the Trustee in Bankruptcy that

there were insufficient funds in the bank accounts and there was insufficient value in the remaining assets for them to receive any return on the money they had invested.

After the bankruptcies it became clear that both Newport Realty Incorporated and Newport Capital Corporation had been operating outside of the law. Newport Realty Incorporated's president and sole director was convicted of twenty-five counts of criminal fraud on August 31, 1990 and was sentenced to three years. During the trial it was also shown that many of the mortgages granted to investors had either never been registered on a property or had been registered on a property already over-encumbered, so that many of the investments were essentially unsecured.

A distinguishing feature of the Newport² bankruptcies was that both the companies had been investigated for regulatory infractions and potential violations under the **Criminal Code of Canada** for the three years prior to the bankruptcies by both the Corporate Investigations Branch of the Superintendent of Brokers, and the RCMP.

How did it come to pass that Newport Realty Incorporated and Newport Capital Corporation, both of which had been under the watchful eye of the Superintendent's office since early 1984, went bankrupt and ended up causing such financial loss to their investors?

The tragedy in this case is not that the Superintendent's office was unaware of the dealings of these two companies; rather it is that the Superintendent's office was well aware of the questionable dealings of the companies but was unsuccessful in preventing the losses that occurred.

A post-mortem analysis of the failure of a company has the advantage of being conducted slowly and carefully. Documents can be assembled, the people involved interviewed and the paper trail followed to its logical conclusion. An examination conducted while a company is in trouble is of necessity more complex and more painful. A post-mortem exercise is valuable not so much for a criticism of what was done, as for prevention of similar future occurrences. By analyzing what happened and why, one is better able to guard against a repeat of similar problems in the future.

The question considered in the Ombudsman investigation was, if the Superintendent's office conducted an investigation into the Newport Realty

² Because of the interconnection of Newport Realty Incorporated and Newport Capital Corporation, I frequently use the word "Newport" to refer to both, which can be read as the context requires.

Incorporated operations, why was it unable to put a stop to those practices that led to investor losses? More specifically the questions considered were:

1. What problems did the Superintendent's office see?
2. What actions did the Superintendent's office take in response to these problems?
3. Why were the actions taken by the Superintendent unsuccessful or insufficient?
4. Could the regulators have taken actions to prevent the losses suffered by the investors?
5. If these losses could have been prevented, what responsibility does government bear to the investors as a result of failing to prevent the losses?

In order to answer these questions I need to review briefly the history of the Superintendent's dealings with Newport Realty Incorporated. The Superintendent's office became aware of problems with Newport Realty Incorporated on four occasions: January 1984, May 1985, January 1986 and August 1986. Each will be examined in turn.

3.0 The Investigations

3.1 The First Investigation: January 1984

Upon receiving the initial complaint from a Newport Realty Incorporated investor in January 1984, the Superintendent of Brokers invoked the powers of the **Real Estate Act** and the **Mortgage Brokers Act** to conduct an investigation of Newport Realty Incorporated. The findings of the Corporate Investigations Branch were disturbing and raised serious concerns, not only about the manner in which Newport Realty Incorporated conducted its business but also about whether the current investors' capital was adequately protected. The reports of the Investigator³ and the Inspector⁴ indicated commercial dealings with the public that were potentially dishonest and unsafe for investors. Strong recommendations for decisive, quick action concluded both the Investigator's and Inspector's reports. The Chief Investigator recommended both a removal of Newport Realty Incorporated's "deemed" registration under the **Mortgage Brokers Act** and a Cease Trade Order under the **Securities Act**.

As a result, although Newport Realty Incorporated's "deemed" registration was not removed, the company was ordered to cease trading in securities, pursuant to section 77 of the **Securities Act**. Cease Trade Orders were generally an effective means by which the Superintendent could "freeze" a situation in order to simultaneously protect the public, assess information in order to determine the true state of affairs and, if necessary, negotiate or order appropriate remedial action. The party named in a Cease Trade Order is enjoined from soliciting funds from the public for the purchase of its securities while the order continues in effect. In this case, Newport Realty Incorporated was ordered to immediately cease accepting money for its mortgage brokering business.

During the period that the Cease Trade Order was in effect (April 9 to December 5, 1984) Newport Realty Incorporated continued selling fractionalized mortgages. When it was brought to the regulators' attention that such selling was occurring, the order was not enforced, because the regulators apparently believed that Newport Realty Incorporated had changed its practice so that the way in which it brokered mortgages no longer constituted trading in securities. This belief arose because of

³ From 1984 until the company's bankruptcy in 1987 one Investigator had responsibility for the Newport file.

⁴ The Inspectors provided forensic accounting skills to the Investigators.

discussions between Newport Realty Incorporated and its representatives and members of the Superintendent's investigative staff. These discussions culminated in a letter from the company's president on July 10, 1984 which outlined a proposed method of conducting the mortgage brokering business which, it was suggested, would remedy the concerns identified by the investigation. Among the obligations Newport Realty Incorporated was to assume was the monthly submission of financial statements with a reporting letter to the Superintendent's office. Consequently, as Newport Realty Incorporated was purportedly no longer trading in securities, the Cease Trade Order would no longer apply to it.

Although subsequent events reveal that the Superintendent's approach was regrettable, it was not unreasonable for the Superintendent's office to have initially accepted the conditions outlined in this commitment letter of July 10, 1984.

3.2 The Second Investigation: May, 1985

Further allegations of improper business dealings were brought to the attention of the Corporate Investigations Branch in May 1985. These were considered by the Director of Investigations to be of such a serious nature that an immediate investigation was initiated. Discussions with Newport Realty Incorporated staff and a brief inspection of their books at the Vancouver office indicated that the company might have reverted to previous unacceptable business practices (Newport Capital Corporation and not Newport Realty Incorporated was apparently making the interest payments to investors). As well, the allegations concerning fraud and misappropriation could not be assessed without obtaining the financial books and records. Although the Deputy Superintendent issued an order for Newport Realty Incorporated to produce its books and records, the investigation ceased before these were obtained and reviewed.

The Ombudsman's examination of the records on file at the Superintendent's office reveals that in the summer and fall of 1985, the branch was indeed involved with many large and time-consuming investigations. Newport Realty Incorporated was but one of several cases demanding attention. Both the Investigators and the Inspectors were seriously overworked during this time. The team consisted of only four Inspectors, one of whom was the senior. One of these Inspectors tendered his resignation in early September 1985 and his position was not filled until the beginning of the next year. The reason why the investigation in June 1985 was not pursued appears to have simply been a lack of communication among the Investigator, Inspectors and their superiors or it may have been an inability to schedule sufficient staff time given other competing demands.

3.3 The Third Investigation: January, 1986

In early 1986, upon the receipt of a new complaint, the investigation was resumed. After a February 25, 1986 inspection at the Newport Realty Incorporated offices, it became clear to the branch that determining where the investors' money was going was the issue. To determine that, it was necessary to obtain the financial records of Newport Capital Corporation and Monterey Homes. Because of the seriousness of their concerns the branch decided to obtain an order compelling access to these books as well as an order to remove Newport's "deemed" registration. On March 20, 1986 Newport Realty Incorporated surrendered its Vancouver real estate license and advised that it

was out of the mortgage brokering business. Newport Realty Incorporated would, nevertheless, not agree to provide the requested books. The branch was not so easily deflected at this stage and prepared to hold a hearing.

The documents on file indicate that the branch was cognizant of the real issue which was where was that the investors' money going. In a letter to the company on March 20, 1986 the Director of Investigations stated:

This office's main function is to prevent losses to the investing public and we are concerned....[that the company]....has raised a substantial amount of funds through newspaper advertisements. It is our responsibility to determine if those funds are being used in a proper manner.

And again, in a memo to his superior the Director wrote:

It is my intention to obtain the necessary orders to obtain these records and conduct a detailed audit to ensure ourselves as to what has happened to the investing public's funds.

A memo dated April 14, 1986 from the Investigator to the Solicitor at the Legal Services Branch requested that a Notice of Hearing be drawn up, including a demand for production of the books and records of, among others, Newport Capital Corporation. The Notice of Hearing, signed by the Deputy Superintendent and dated April 30, 1986 made no such demand. It is significant to note that Newport Realty Incorporated shortly following voluntarily surrendered its license on May 20, 1986.

The hearing began on June 18, 1986 and continued on July 14, 1986. The hearing lasted four days. At the conclusion of the hearing on July 22, the Deputy Superintendent reserved his decision. The decision was not rendered until December 12, 1986. The public was not given notice of the decision until February 3, 1987, approximately two weeks before Newport Realty Incorporated and Newport Capital Corporation declared bankruptcy.

In his decision the Deputy Superintendent said:

"In summary, each client believed himself to be doing business with their (sic) agent, Newport Realty, who, in turn, through the receipt, contracted to invest in a specific fractionalized first mortgage that was registered....mortgage funds invested by members of the public with [the president of the company]....and Newport Realty totalled a considerable amount. I find evidence of irregularities in the operation of Newport Realty

as a mortgage broker that arises from extremely serious mismanagement or from misappropriation of client investments by Newport Realty and its representatives. I further find that Newport Realty has tendered no satisfactory explanation for those irregularities....

*I also find that....[the president of the company]....in becoming involved with clients as a representative of the company in respect to these mortgage transactions, should have been registered himself under the **Real Estate Act** or **Mortgage Brokers Act**....*

In view of the foregoing, I am of the opinion that cancellation of Newport Realty's license is necessary in the public interest and hereby so order, effective as of May 20, 1986 when its license was surrendered."

3.4 The Fourth Investigation: August, 1986

The Investigator was aware in June, 1986 that Newport Capital Corporation was issuing promissory notes to Newport Realty Incorporated investors. His notes indicate that he was aware that Newport Capital Corporation had switched properties for at least one investor. On August 5, 1986 he became aware, through a complainant who visited his office, that Newport Capital Corporation had also taken in mortgage funds. Newport Capital Corporation was doing, effectively, what Newport Realty Incorporated had been doing. Despite the fact that Newport Capital Corporation had no license to operate as a mortgage broker, no action was taken to stop Newport Capital Corporation's illegal mortgage brokering. Further complaints in the fall of 1986 indicated that Newport Capital Corporation was continuing its mortgage brokering business. At no point, even after these additional complaints, did the Superintendent's office take any action to stop Newport Capital Corporation's illegal mortgage brokering. In fact, serious action was not taken until just shortly before Newport Realty Incorporated declared bankruptcy in February, 1987.

The investigative staff have informed my Office that they were expecting the Deputy Superintendent's decision regarding Newport Realty Incorporated to be released imminently and they believed that it would resolve the "situation." That there was such a lengthy delay in handing down the decision is regrettable, particularly given the staff's reliance on the outcome and the need for action to be timely.

The Superintendent's office was not precluded, however, from taking action while awaiting the decision. Regardless of the Deputy Superintendent's findings relating to Newport Realty Incorporated, from August 5, 1986 on, it was known that Newport Capital Corporation and the president, neither of whom were registered and thereby authorized to engage in mortgage brokering, had been soliciting funds from investors. In my opinion, immediate investigation of Newport Capital Corporation ought to have been undertaken.

The inaction of the Superintendent's staff is difficult to understand, particularly given the lengthy and detailed investigation that had been carried out by the Investigator. Clearly, the staff had been frustrated in its dealings with the company. It may be that they believed that the Deputy Superintendent's decision would resolve the problem. Their lack of direct action could also have been the result of their belief that criminal charges would be laid imminently as the RCMP had undertaken its own investigation.

The decision of the Deputy Superintendent, finally rendered on December 12, 1986, confirmed the initial findings that the investing public was insufficiently protected and had been at risk. It is reasonable to assume that the decision, though delayed, should have acted as a catalyst for new action to put Newport Capital Corporation and its principal out of business.

The regulatory inaction following the December 12, 1986 decision, given both the reliance being placed on the decision being made, and the knowledge that Newport Capital Corporation was actively brokering mortgages, is puzzling and troubling. Of even greater concern is the fact that the decision was not published until a month and a half after being rendered, during which time several more persons made new investments.

4.0 Analysis

The investigation of the Newport Group by the Corporate Investigations Branch involved three provincial statutes: the **Mortgage Brokers Act**, the **Real Estate Act** and the **Securities Act**.⁵ The **Mortgage Brokers Act** requires all persons engaged in the mortgage brokering business to be registered pursuant to the **Act**. Persons licensed under the **Real Estate Act** are deemed to be registered under the **Mortgage Brokers Act**. Newport Realty Incorporated was licensed under the **Real Estate Act**, and hence the **Mortgage Brokers Act** as well. Neither the president of the companies in the Newport Group nor Newport Capital Corporation were registered under any **Act**. The **Securities Act**, prior to 1986, required registration to trade in securities, including mortgages, except under specified conditions. Mortgage brokers generally did not register under the **Securities Act** nor did the Superintendent enforce this requirement.

Regardless of whether a company or an individual is registered, these three **Acts** provide the regulator with many ways, in combination or separately, to enforce substantive regulatory operating requirements and thereby protect the investing public. Each **Act** contains powers to investigate companies, individuals and their business activities. Hearings may be called at which witnesses may be compelled to give evidence and produce corporate books and records. Books may be examined and in some cases seized. Bank accounts may be frozen and withdrawals prohibited. Orders directing the cessation of advertising or trading in securities are another tool regulators can use to protect the public. In appropriate cases **Criminal Code of Canada** powers, such as the use of search warrants, may be employed. These powers, when appropriately utilized by a prudent regulator, are capable of terminating the operations of an unscrupulous broker who is operating in a manner detrimental to the public.

The information necessary to justify use of these powers was known to the Corporate Investigations Branch. It is clear that while some powers were used, others that were at the disposal of branch staff were not. Had the full range of powers been exercised, it is reasonable to conclude that both Newport Realty Incorporated and Newport Capital Corporation could have been put out of business prior to the bankruptcies in February 1987, if not as early as the summer of 1986.

⁵ The *Criminal Code of Canada* was ever present in addition to the regulatory statutes and eventually was utilized by the Attorney General to lay charges against the principal with respect to his involvement with Newport Realty Incorporated and another company.

4.1 Why were the full powers provided by the statutes not utilized?

It is impossible to blame the action or inaction of any one individual for investor losses. I have identified at least four different reasons why the full powers noted above were not exercised adequately; poor inter-office communication, understaffing of regulators, over-reliance by the regulators on the RCMP and over-reliance by the Investigations Branch on the Deputy Superintendent's decision. I will address each of these in turn.

4.1.1 Poor inter-office communication

On August 6, 1987, the Ministry of Finance and Corporate Relations produced an internal report entitled **Newport: Summary of Regulatory Action 1984-1987**. The report provided an interesting and thoughtful critique of the Newport Realty Incorporated investigation. One point discussed in the report, with which I concur, dealt with the impact upon the investigation of the relationship between the organizational structures. The criminal investigation relied upon numerous experts, including Investigators, accountants, lawyers, police and other decision makers. Their working inter-relationship was neither cohesive nor organized. I concur that this lack of cohesion and cooperation would clearly be to the benefit of any person(s) seeking to avoid regulatory attention.

Another area of poor communication existed between the Inspectors section and the Investigators section. Apparently the contents of the July 10, 1984 proposal from Newport Realty Incorporated were not reviewed and assessed by an Inspector. Such an assessment could have been very helpful in defining one of the terms whereby Newport Realty Incorporated was to submit to the Superintendent of Brokers, on a monthly basis, financial statements regarding the service and application of mortgage funds. This was a critical element in the proposal because it would have provided the primary and focused monitoring mechanism for the branch. Input from an Inspector concerning what essential information was required might have better defined the terms and thus hindered Newport Realty Incorporated's questionable activity and perhaps warned the branch of it sooner. Newport Realty Incorporated was sending in misleading monthly reports. However, it was easy for this to be done because Newport Realty Incorporated was not required to submit much in the way of content or substance.

Further problems arose because of the apparent absence of clear communication between the investigative side and the Deputy Superintendent's office regarding both the subject matter of the decision and the length of time it took for the decision to be rendered.

4.1.2 Understaffing of regulators

It is clear to me that understaffing was a major problem for the Corporate Investigations Branch during the mid-eighties. The shortage of staff may well account for the fact that there was no follow-up on the monthly financial statements sent in by Newport Realty Incorporated after June 1984. It would certainly help explain the incomplete investigation of Newport Realty Incorporated and Newport Capital Corporation in June 1985. It is my view that the Corporate Investigations Branch was seriously understaffed and heavily overworked in the period of 1984-85. When a government chooses a mandate, enacts legislation that imposes responsibilities on itself, delegates those responsibilities to regulators, and then fails to appoint enough individuals to carry out the required tasks, it cannot excuse itself from its statutory responsibilities. When there is serious wrongdoing and potential and substantial public risk, it is appropriate for government to accept ultimate responsibility if personnel are unable to fulfill the statutory responsibilities. In my view when a statutory responsibility is relaxed because of shortage of staff, inadequate allocation of resources amounts to administrative negligence.

4.1.3 Over-reliance by the regulators on the RCMP

Throughout the branch's investigation, there was co-operation, particularly in the form of information exchange, between the Investigators and the RCMP. Perhaps because of the extensive communication between the two operations, the branch Investigators appeared, to some extent, to rely on and take comfort in the RCMP involvement.

Yet, during the 1984 to 1987 period, the RCMP investigation was directed towards Newport Realty Incorporated's president and the transactions of another of that individual's companies. Furthermore, it was not until January 1987 that the branch made a formal referral to the RCMP concerning the individual involved and the Newport Realty Incorporated mortgage brokering business. As the report from the Ministry of Finance and Corporate Relations pointed out, the issues and focus of a criminal investigation are different from those of a regulatory investigation. The fact that a criminal investigation is in progress should not invite any complacency or over-reliance on the part of the regulatory agency. This is especially so when the criminal investigation

involves different events and business activity than those confronting the regulators. It might have been more appropriate for the branch to have referred the Newport Realty Incorporated case to the RCMP in 1985 when they learned of allegations of fraud and misappropriation of funds with respect to Newport Realty Incorporated (especially since they did not appear to have the resources to investigate these allegations fully at that time).

4.1.4 Over-reliance by the Investigations Branch on the Deputy Superintendent's decision

Finally, there was also an undue reliance placed on the decision to be handed down by the Deputy Superintendent after the hearing into Newport Realty Incorporated concluded in July 1986. The Investigator stated his reliance on this decision as one explanation for why, on August 5, 1986, when he came to understand that Newport Capital Corporation had entered into the mortgage brokering business, he did not pursue the claim. The Investigator appears to have misunderstood the legal scope and effect of the Superintendent's decision, which related to Newport Realty Incorporated and not Newport Capital Corporation. Clearly, action could have been taken against Newport Capital Corporation prior to the decision and certainly immediately after it was rendered.

In my opinion, therefore, the combination of the above four factors led to the inadequate use of statutory powers which, in turn, contributed to the investors' losses.

Having determined that a different course of action by government regulators could have prevented the loss suffered by the investors, the question of government responsibility must be addressed. In the past decade, there have been increasing demands on government to assume liability for the financial losses incurred by investors in regulated markets. At one time investment markets were virtually unregulated. Government, however, has become gradually more involved in the marketplace through the creation of statutory rules and sanctions. Government "watchdog" agencies have been established. As a result of this expanded involvement in the financial marketplace, new pressures have been placed on government to consider itself a guarantor of the market in certain kinds of investment situations. It is useful, therefore, to address the relationship government bears to the investing public as a result of its legislation and related organizations.

5.0 Government as Regulator

The British Columbia statutes relevant to the Newport Realty Incorporated case show an intention on the part of government to protect the investor from dishonest and incompetent business people, and from inherently unsafe investments. In positive terms, the legislation strives to create a market foundation that promotes honest, open and competent business dealings.

The registration and licensing requirements aim to ensure a minimal level of competence and suitability in those individuals and companies wishing to sell, trade and broker, in one form or another, the public's money. Advertising and prospectus requirements aim to provide investors with the minimally acceptable amount and type of accurate information prior to their making an investment decision. Finally, the investigative and sanction provisions act as an enforcement arm to deter fraudulent dealing, to protect the public and to ensure the attainment of the statutory goals. It should be noted that the job description for the Superintendent at the time of the Newport Realty Incorporated investigation stated that "...the primary goal of all of these activities is the protection of the investing public."

How well the government achieves these aims, beyond the mere enactment of legislation, is determined in part, by resource allocation. Ideally, the resources allocated for the implementation of a statutory mandate would be adequate for the complete achievement of that mandate. The reality, of course, is that government must choose among competing needs and programs when allocating its finite resources. However, if government assigns itself mandatory statutory duties, then as a minimum requirement, it should meet them. In order to do so it must provide adequate staff and resources to discharge the statutory requirements.

As a result of its legislation, and particularly in light of its knowledge of Newport's activities, the government had a substantial responsibility to Newport Realty Incorporated investors. This responsibility was, at all times, clearly recognized by the investigative staff. In failing to discharge the statutory responsibility adequately after August 5, 1986, both the regulators and the government failed to carry out the mandatory duty the government had set for itself.

The major losses that occurred after August 5, 1986 were reasonably foreseeable and, in all probability, preventable by the regulators. The lack of effective regulatory action was not, in my opinion, a result of considered public policy or the *bona fide* exercise of discretion, but rather the result of a

combination of poor decision-making, inadequate staff, undue reliance on others and poor communication.

August 5, 1986 may be distinguished from July 1984, June 1985 and the spring of 1986 regarding governmental responsibility for investor losses. At each of the latter three times the regulators, once apprised of a concern, took action even though hindsight shows that the regulatory actions taken in July 1984, June 1985 and the spring of 1986 were insufficient.

If regulatory action - even if insufficient - was evidenced during July 1984, June 1985, and the spring of 1986, regulatory inaction characterizes the situation after August 5, 1986. The fact that from this date the regulators knew that Newport Capital was brokering mortgages illegally, had the power to take action yet did nothing to stop it, constitutes administrative negligence and attracts responsibility. I find, therefore, that the government is responsible to provide some compensation to the investors in this case.

6.0 Recommendations

An investor's expectations of, and reliance on government as a regulator may in some cases be unrealistic. She or he may put too much trust in government regulators and may be uninformed about the responsibilities of the regulators. No legislation requires legislators or the administrators of the regulatory apparatus to provide easily available information to the public, describing the regulator's purpose and functions. Although not required by law, it is clearly desirable that the government should, as a matter of good administrative practice, make such information available to the public in order that the government's role as a regulator in the marketplace be clear and well understood. Clearly, investors accept certain degrees of risk with any investment. Nevertheless, as the financial marketplace grows more complex, it is important for government to inform investors of the risks so that they can make their decisions in a knowledgeable fashion.

I made three recommendations to the government aimed at improving public protection by making pertinent information available and providing for compensation for those investors who lost money as a result of administrative negligence. These were:

1. Recommend that the Financial Institutions Commission publish an information brochure describing its role in the financial marketplace.

A pamphlet or brochure that describes the nature of the non-securities markets, who the regulators are, what the regulators do (and do not do) and how to contact the regulators, would provide a useful primer to the non-corporate investor. Such a pamphlet could:

- dispel misconceptions held by investors by clarifying the role of the government,
- inform investors of the basic framework within which certain markets must operate, and
- list names and numbers of persons to contact for inquiries and information.

The pamphlet could play a role in preventing unwise investments arising from the misrepresentations of fraudulent operators.

Government Response:

The Financial Institutions Commission responded by quickly putting such information into the marketplace in the form of brochures dealing with the financial sectors that it regulates. Currently it produces a general "Information Bulletin" that outlines its role and provides telephone and fax numbers for assistance. As well, it produces regular bulletins that provide timely information on current issues within its areas of jurisdiction.

The general bulletin is available at:

- *offices of Government Agents*
- *libraries throughout the province*
- *Financial Institutions Commission office*
305-1095 West Pender Street
Vancouver, B.C. V6E 2M6
Phone: (606)666-5335
Fax: (604)666-6717

2. Recommend that the Financial Institutions Commission develop a policy whereby the public is alerted to possible violations of the legislation.

A comprehensive disclosure policy with respect to specific cases would further protect the investing public. When the regulator has imposed a specific regulatory sanction or when the operating status of a company has changed, an investor should be able, without difficulty, to obtain such information about a specific investment. For the disclosure policy to be effective, it is critical that information concerning a company's or individual's legal authority to transact business be readily available to the public.

The surrender by Newport Realty Incorporated of its licenses and the regulatory sanctions imposed upon it initially took place outside the realm of public knowledge and therefore were incapable of stimulating an appropriate public response. An informed public is essential when dealing with businesses that disregard or attempt to circumvent regulators' efforts. These businesses must be deprived of their natural market through the dissemination of clear and accurate public information in a timely manner. This is not to imply that in the Newport Realty Incorporated case the regulators ought to have advised investors that they were in the process of an investigation. This would be unfair

and prejudicial both to those being investigated, and in some cases, to existing investors. However, had the public been aware of the surrender and the later cancellation of Newport Realty Incorporated's licenses this information might have prevented many individuals from investing with Newport Realty Incorporated or from renewing current investments with them.

Government Response:

The Financial Institutions Commission responded by quickly developing a "Disclosure Policy" to address these issues. Under certain circumstances, when the financial stability or continuity of a company is in question, the Superintendent of Financial Institutions will issue a press release or, if the circumstances are more urgent, will make an announcement on the radio or in the newspapers.

- 3. Recommend that the Ministry of Finance and Corporate Relations appropriately compensate those individuals who had invested in Newport Realty Incorporated and Newport Capital Corporation after August 5, 1986, when the Corporate Investigations Branch knew that illegal sales were occurring and yet took no steps to halt them.**

The issue of compensation is a more difficult one. As noted above, except for the period after August 5, 1986, the failure of the Superintendent's office was not that it did not try to control Newport's illegal activities but that it failed to be successful. For that reason I do not think compensation is appropriate for the period before August 5, 1986. It is one thing to hold a regulator accountable for failing to do its duty; it is another entirely to hold it accountable for being unsuccessful. The situation after August 5, 1986 is different. Here, as noted, the regulators saw problems but did not act to put an end to them. Here their inaction attracts responsibility for which they should be held accountable. By August 5, 1986, even if Newport Realty Incorporated had been put out of business immediately, investors would likely have recovered very little of their investment. Therefore, the government should compensate the investors for only a portion of the losses.

Government Response:

After a great deal of time and discussion the government has agreed to compensate those investors 25 per cent of their principal as of the date of the bankruptcy (February 17, 1987 for Newport Realty Incorporated and February 19, 1987 for Newport Capital Corporation) with no interest being paid.

I recognize the percentage for compensation is low. I am, however, prepared to accept the government's offer as both an acknowledgment of administrative negligence and an attempt to provide some measure of long awaited redress to affected investors.