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Enforcement Effectiveness in the Canadian Capital Markets

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Enforcement Effectiveness in the Canadian Capital Markets

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Executive Summary

Enforcement has been identified as one of the most critical issues concerning Canadian capital markets stakeholders. Effective enforcement by regulators is critical to achieving the policy objectives underlying securities regulation. However, public enforcement is only one part of a comprehensive enforcement strategy, which includes private enforcement through the courts and other mechanisms as well as investor education initiatives.

Part of the divisiveness surrounding the contemporary debate on regulatory enforcement in Canada appears to be related to the disconnect between securities regulators and investors in interpreting the mandate of investor protection. While regulators exercising their powers of enforcement have generally interpreted their mandate as forward looking and grounded in principles of deterrence, aggrieved investors are most interested in being made whole as a result of capital markets misconduct. The time may be ripe to re-conceive of the role of the securities regulator in the 21st century as one that, in addition to taking enforcement actions on the basis of the principle of deterrence, also acts as a catalyst or facilitator to assist investors in receiving compensation for harms suffered in the capital markets.

The threat of criminal prosecution can act as a real and significant deterrent to regulated market participants. However, *Criminal Code* prosecutions should be reserved for the most egregious cases of capital markets misconduct. As such, the Integrated Market Enforcement Team's (IMET) strategy of expending significant resources on a very small number of investigations is a reasonable and appropriate one. However, the goals underlying the creation of IMET are unlikely to come to fruition unless appropriate attention is also paid to the role of the judiciary in the criminal law process. Historically, judges have imposed nominal fines on corporate offenders that can be written off as a cost of doing business. Judges should be provided with greater context-training and education so that they recognize and appreciate the magnitude and impact of corporate misconduct on large segments of the population, and the broader ramifications of capital markets crimes on the Canadian economy. Serious consideration should also be given to the creation of specialized courts for *Criminal Code* offences related to capital markets wrongdoing and quasi-criminal charges under provincial securities laws.

Securities regulators need to structure the broad discretion that has been afforded to them so that they have a principled, rational and justifiable basis on which to pursue their enforcement agendas and activities. The recent events at the Alberta Securities Commission underscore the need for a disciplined enforcement system that has clear enforcement policies, guidelines and standards, as well as consistency in enforcement processes and appropriate analysis and reasoning to support conclusions and recommendations on files. To the extent that some Canadian securities regulators have not done so already, they should be encouraged to create, justify and publicly disclose the factors that they take into account in deciding which enforcement actions to pursue.

Effective enforcement requires a high-level of co-operation, co-ordination and communication among Canadian securities regulators. The current regulatory structure would benefit from greater co-ordination and co-operation in relation to enforcement policy-setting and priority-setting. A system should be devised to recognize sanctions imposed by one securities commission in other Canadian jurisdictions. In this regard, a national commission or consolidated regulator would enhance enforcement effectiveness by allowing for policies and priorities to be set at a national level. Sanctions would also be more consistent and effective across the country. Attention should also be paid to technical and policy issues related to co-operation and co-ordination with foreign jurisdictions, particularly regulators in the U.S.

Canadian securities regulators should continue to collect and disseminate data on raw inputs and outputs to the public: size of enforcement staff and budgets, the number of files opened and closed and the number of hearings and settlements. However, greater effort should be made to *analyze* the impact of enforcement inputs and outputs on the actual behaviour of regulated market participants.

Investor perceptions about Canada's enforcement effectiveness relative to other jurisdictions, in particular the U.S., are important and need to be addressed, in light of the increased mobility of capital in today's global economy. In comparing Canadian and U.S. data on enforcement, one needs to take into account differences in statutory authority afforded to the securities regulators as well as practical differences in the handling of cases. Canadian securities regulators should educate the investors, the press and the public about these differences but at the same time consider adopting best practices and policies from other jurisdictions to the extent that they may enhance enforcement effectiveness in the Canadian capital markets.

1. Introduction*

Enforcement has been identified as one of the most critical issues concerning Canadian capital markets stakeholders today. Investors vehemently make the case that there is insufficient enforcement activity, that the small investor is not well protected, that the commissions have been captured by those they regulate, and that the self-regulatory organizations (SROs) are unable to engage in effective enforcement because of perceived or actual conflicts. Meanwhile, market participants, such as registrants, issuers, officers, and directors, and well as gatekeepers to securities markets, complain that enforcement by regulators is “out of control.” They argue that there is too much enforcement activity taking place, and that the governance structures at the commissions and the SROs create conflicts to their detriment.

Effective enforcement by regulators is critical to achieving the policy objectives of securities regulation, most often cited as protecting investors, enhancing the efficiency of the capital markets and maintaining a high level of public confidence in the markets.

These policy goals are achieved through a variety of instruments and a range of institutions. In the context of the Canadian capital markets, relevant institutions include the provincial securities regulators and SROs such as the Investment Dealers Association (IDA), the Mutual Fund Dealers Association (MFDA) and Regulation Services (RS). Municipal, provincial and federal law enforcement agencies, the attorneys-general, and the judiciary are also important institutions. For the purposes of this paper, all of these institutions are labelled “regulators” even though it is acknowledged that there are significant differences among them.

Securities regulation focuses on numerous classes of people or entities that are involved in the capital markets, including issuers, directors, officers, registrants and gatekeepers, such as auditors and lawyers. For the purposes of this paper, all of these parties are labelled “regulated market participants” even though there are significant differences amongst the market participants in terms of the instruments that are used to regulate them.

This paper focuses on the fundamental principles underlying effective enforcement by regulators. In particular, this paper analyzes the critical role of the criminal law and judges in effectively addressing capital markets misconduct. It also

* The research assistance of Sultana Yusufali, Carmen Choi, and Anna Tennenbaum is gratefully acknowledged. Thanks are owed to the Capital Markets Institute and in particular to Paul Halpern, Doug Harris and Atanaska Novakova in conceiving of this timely project and for their continued input and support. Thanks are also owed to all participants at the CMI Roundtable and CMI Conference for insightful comments and suggestions. Earlier versions of this paper were presented at the CMI Roundtable in December 2004, a Faculty Workshop at the University of Windsor, Faculty of Law in February 2005, the Business Law at the Border Conference at the Canada-America Research Centre of the University of Windsor Faculty of Law in June 2005, and a CMI Conference in June 2005.

analyzes how securities regulators can best structure the wide discretion that is afforded to them in designing enforcement strategies and policies that are effective, fair, transparent and accountable. This study also examines the current allocation and division of enforcement responsibilities in respect of the capital markets amongst the numerous entities involved and explores contentious issues related to the current overlapping and concurrent jurisdiction. Finally, this study examines the issue of data and in particular, data comparisons on enforcement effectiveness with the United States.

This paper focuses on the regulatory enforcement stage and does not address issues related to non-compliance by regulated market participants as a result of poor rule-making or instrument design by regulators. However, there may be a variety of reasons at the rule design stage that may lead to latter non-compliance by regulated market participants.¹ For example, compliance with the rule may be too costly or complex, the transition time may be too short, the rules may be too inflexible, or the market participants may not have been consulted prior to it being created.²

Part 2 of this paper briefly establishes the link between the policy objectives of securities regulation and enforcement activity. Part 3 analyzes the role of public enforcement in a comprehensive enforcement strategy and considers whether public regulators should play a role in facilitating private enforcement. Part 4 sets out the theory of the regulatory pyramid and applies its underlying principles to determine the appropriate role of the criminal law, sanctions and judges. Part 5 analyzes issues related to structuring the broad discretion afforded to securities regulators. Part 6 highlights some of the most critical issues arising from the current overlapping structure of enforcement in Canada. Part 7 analyzes issues related to collecting data on enforcement activities and comparing enforcement effectiveness with other jurisdictions, in particular the United States. Part 8 concludes.

2. Relationship between Enforcement and the Policy Objectives of Securities Regulation

Following the corporate governance scandals and accounting improprieties of recent past, and the passage of the *Sarbanes Oxley Act of 2002* in the United States, Canadian capital markets stakeholders engaged in a vigorous debate on the appropriate Canadian regulatory response. As a result, we witnessed a flood of substantive securities law reform, in areas including auditor independence,³ director independence,⁴ the role

¹ Reducing the Risk of Policy Failure: Challenges for Regulatory Compliance, Organization for Economic Co-Operation and Development [OECD Report].

² *Ibid.*

³ See, for example, National Instrument 52-108 Auditor Oversight.

⁴ See, for example, National Instrument 58-101 Disclosure of Corporate Governance Practices and National Policy 58-201 Corporate Governance Guidelines.

and composition of the audit committee,⁵ and CEO/CFO certification of financial disclosure.⁶

The federal government also focused its efforts on enhancing investor confidence in the Canadian capital markets by creating Integrated Market Enforcement Teams (IMET) across the country as well as new *Criminal Code* offences of insider trading, tipping and whistleblower retaliation.⁷ The federal government is also considering amendments to the *Canada Business Corporations Act* (CBCA) to heighten corporate governance requirements.⁸

However, this recent regulatory reform is meaningless unless it is accompanied by compliance from the regulated market participants and effective enforcement by regulators. Empirical studies show that strong enforcement activity is correlated with enhanced investor confidence and a reduced cost of capital.⁹ Equally as important as the substantive legal rules on the books is actual compliance with them by regulated market participants and their enforcement.

3. The Appropriate Role of Public Enforcement in a Comprehensive Enforcement Strategy

The main criticisms of enforcement activity in Canada have focused on public enforcement by securities regulators and SROs. However, a comprehensive enforcement strategy entails not only effective enforcement by public regulators but also private enforcement mechanisms that allow investors who are injured by capital markets wrongdoing to seek redress. A comprehensive enforcement strategy also includes preventive measures and investor education programs.

It is beyond the scope of this paper to explore in detail issues related to private enforcement but it is an extremely important aspect of compliance and enforcement. In fact, some recent studies have concluded that the strength of private enforcement mechanisms is actually more important than public enforcement mechanisms in achieving the underlying policy objectives of securities regulation.¹⁰ To this end,

⁵ See, for example, Multilateral Instrument 52-110 Audit Committees and Companion Policy 52-110.

⁶ See Multilateral Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings and Companion Policy 52-109; See also Proposed Multilateral Instrument 52-111 – Reporting on Internal Control Over Financial Reporting: Canada's Response to s.404 of Sarbanes-Oxley; for a critique of proposed 52-111, see National Post (May 25, 2005) where Domenic D'Allessandro, CEO, Manulife Financial Corporation states that SOX s.404 is "extraordinarily onerous" and will "cost an estimated \$30 million CDN per year to implement."

⁷ An Act to Amend the *Criminal Code* (Capital Markets Fraud and Evidence Gathering) Third Session, Thirty-Seventh Parliament, 52-53 Elizabeth II, 2004 (Bill C-13).

⁸ Towards An Improved Standard Of Corporate Governance For Federally Incorporated Companies: Proposals For Amendments To The *Canada Business Corporations Act* (Industry Canada, Ottawa).

⁹ See, for example, Bhattacharya & Daouk "The World Price of Insider Trading" (200?) 57 Journal of Finance 75.

¹⁰ Rafael LaPorta, Florencio Lopez-de-Silanes and Andrei Shleifer, "What Works in Securities Laws." (June 11, 2004) Available at

effective private enforcement mechanisms should allow for timely and cost-effective adjudication or resolution of meritorious claims but have sufficient thresholds and procedures in place to prevent frivolous and vexatious claims. Recent developments in Canada such as class actions legislation and contingency fees have a favourable impact on the effectiveness of private enforcement by aggrieved investors through the court system. The Ontario government's announcement that amendments to the *Securities Act (Ontario)*, introducing statutory civil liability for misrepresentations in continuous disclosure documents and failure to make timely disclosure, which will be brought into force on December 31, 2005, is a welcome development in this regard. The IDA's arbitration program and the Financial Services Ombudsman should also be evaluated to determine if they are meeting their intended policy objectives.

Part of the divisiveness that surrounds the contemporary debate on enforcement in Canada appears to be related to the disconnect between securities regulators and investors in interpreting the mandate of investor protection. Regulators have historically interpreted their mandate as forward-looking and deterrence-based. Various legal decisions have certainly underscored that the role of the securities regulator is protective and preventive, not remedial, compensatory or punitive.¹¹ However, individual investors who have lost their savings due to the misconduct of regulated market participants are most interested in being compensated. They conceive of the securities regulator's role in protecting investors as helping them to be made whole and they are interested in seeing securities regulators play a greater role in facilitating compensation for their losses.

It may very well be time to re-conceive of the role of the securities regulator in the 21st century, as one that not only takes forward-looking actions, but also one that acts as a facilitator or catalyst to assist investors in receiving compensation. While some securities commissions, including the OSC, do already have statutory powers to apply to the court for restitution or compensation orders, the OSC, for example, has only done so once.¹² Further study should be undertaken on reasons why securities regulators have not historically made use of this provision, and securities commissions should be encouraged to use this power more frequently. Serious further consideration should also be given to

http://mba.tuck.dartmouth.edu/pages/faculty/rafael.laporta/working_papers/WhatWorksInSecuritiesLaws/securities06112004complete.pdf (Last accessed: November 27, 2005). But see also Robert Yalden, "Legislative Deference and Canadian Securities Regulators: Lessons from the Debate on Civil Liability for Continuous Disclosure" (Working Draft dated October 19, 2004, on file with author), in which he argues that expanded private enforcement and in particular statutory civil liability for continuous disclosure is not as necessary in Canada as it may have been even a few years ago in light of the recently expanded resources and powers of public securities regulators.

¹¹ See *Committee for the Equal Treatment of Asbestos Minority Shareholders v. Ontario (Securities Commission)* [2001] 2 SCR 132; See also *Re Albino* (1991), 14 OSCB 365; See also *Re Mithras Management Ltd.* (1990), 13 OSCB 1600.

¹² Five Year Review Committee Final Report: Reviewing the Securities Act (Ontario) (March 21, 2003). Available at: http://www.osc.gov.on.ca/Regulation/FiveYearReview/fyr_20030529_5yr-final-report.pdf. (Last accessed November 27, 2005).

allowing securities commissions the ability to order restitution or compensation under their public interest power.¹³

4. The Regulatory Pyramid: The Role of the Criminal Law, Sanctions and Judges

Compliance is optimized by regulation that is contingent, co-operative, tough and forgiving.¹⁴

Studies in various regulatory settings show that compliance is best achieved when regulators have available to them a range of enforcement sanctions, strategies and approaches.¹⁵ The basic principle is that “softer”, less harsh approaches should be used more frequently and before tougher, more severe approaches are considered.

The *availability* of and *possible* application of tougher, more severe approaches will act as a deterrent for most market participants and propel them to comply. Actual, frequent application of tough approaches is not necessary and may lead to overall greater non-compliance. This approach is characterized by a regulatory pyramid which suggests that regulators should use good will, co-operation and persuasion to achieve compliance before resorting to harsher, stricter sanctions.

(i) The Appropriate Role of the Criminal Law

Based on the principles underlying the regulatory pyramid, sanctioning options should be tiered from the most compliance/deterrence based to the most punitive. Most cases of non-compliance should be dealt with by attempting to get regulated market participants who are not abiding by the rules to do so. In the context of the misconduct in the Canadian capital markets, it is appropriate that securities commissions rely significantly on their public interest powers to pursue administrative sanctions with a focus on deterrence. Securities commissions also have available to them quasi-criminal sanctions through the court system but have not historically made use of them. There has been a bit more interest in using this route recently, but nonetheless securities commissions should be encouraged to use this channel more frequently. The criminal

¹³ See the Five Year Committee Final Report, *Ibid*, Recommendation 75:

We recommend that the Commission monitor the exercise by the Manitoba Securities Commission and the FSA of their new restitution powers and consider the practical implications of the exercise of this power, with a view to revisiting in the future whether a power to order restitution would be an appropriate remedy for the Commission.

¹⁴ I. Ayres and J. Braithwaite, (1992), *Responsive Regulation: Transcending the Deregulation Debate*, Oxford University Press, New York.

¹⁵ See OECD Report, *supra* note 1; See also J. Braithwaite and T. Makkai, “Trust and Compliance” 4 (1994) *Policing and Society*; B.Fisse and J. Braithwaite, *Corporations, Crime and Accountability*, (Cambridge: Cambridge University Press, 1993); Malcolm Sparrow, *The Regulatory Craft*, (Brookings Institute Press, 2000).

law, at the apex of the regulatory pyramid, should be used sparingly. In my opinion, *Criminal Code* prosecutions should be reserved for only the most egregious cases of capital markets misconduct and should be used as a last resort of recalcitrant offenders.

Historically, very few capital markets prosecutions have been pursued by criminal law authorities and even fewer have been successful. This was largely the result of a lack of resources, and a perceived or actual lack of interest and expertise on the part of the various entities involved: law enforcement agencies, crown attorneys, and judges. Capital markets offences are complex, involve multiple actors, and are often more difficult to prove than traditional crimes. Unlike most traditional criminal law matters, the resources of the defendant can parallel the government's resources. There are also the theoretical and doctrinal difficulties and complexities of imposing criminal liability on corporate wrongdoers.¹⁶

On the issue of resources, Superintendent John Sliter, the Director of IMET, wrote in his 1994 masters of business administration thesis at Simon Fraser University that competition for resources between police services is a problem, noting that "the policy relating to payment of confidential sources providing information with respect to multimillion-dollar securities frauds is basically the same for payments to persons for providing information on break-and-enter offences."¹⁷

In an effort to enhance investor confidence and sustain Canada's economic growth, the federal government committed up to \$120 million in late 2002 to create IMET.¹⁸ By doing so, the federal government signalled its intent to more effectively use the criminal law power as a tool to combat capital markets misconduct. The interdisciplinary teams, which include RCMP investigators, lawyers and forensic accountants, are "dedicated to the investigation and prosecution of serious *Criminal Code* of Canada capital markets fraud offences that are of national significance and involve actions by publicly-traded companies with sufficient market capitalization to pose a genuine threat to investor confidence in Canada's capital markets and economic stability in Canada."¹⁹ There are currently six IMET teams across the country: three in Toronto and one in each of Vancouver, Calgary and Montreal.

Has IMET been effective in achieving its mandate? It is simply too early to tell, given that most of their files are still under investigation and investigations are not

¹⁶ See, for example, the discussion in P.Puri, "Sentencing the Criminal Corporation", (2001) 39 OHLJ 611. But see also An Act to Amend the *Criminal Code* (Criminal Liability of Organizations), 2nd Session, 37th Parliament, 51-52 Elizabeth II, 2002-2003. (Bill C-45) which changes the doctrinal basis of corporate criminal liability in Canada.

¹⁷ "The Mounties (very often) get their man; But do 'Dudleys' do right by the investor?" Investment News May 23, 2005.

¹⁸ "The IMETs help fulfill a commitment made in the 2002 Speech from the Throne and Budget 2003 to spend up to \$120 million over the next five years to boost investor confidence in Canadian financial markets and sustain Canada's economic growth." See http://www.rcmp-grc.gc.ca/news/2003/n_0351_e.htm. (Last accessed November 27, 2005).

¹⁹ See http://www.rcmp.ca/fio/imets-faq_e.htm (Last accessed November 25, 2005).

generally disclosed to the public. As of May 2005, IMET had at least 33 investigations ongoing (7 active investigations and 26 somewhat less serious probes) involving public companies with a total market value exceeding \$55 billion.²⁰ Investigations that are ongoing and have been made public involve Nortel and Royal Group Technologies.²¹ It was also recently announced that the Vancouver IMET is investigating the possibility of criminal conduct at the Alberta Securities Commission.²²

IMET has only recently laid its first significant charges in June 2005 on former senior executives of Betacom under section 380 of the *Criminal Code*.²³ The Toronto IMET investigation began in March 2004 as a result of a referral from the OSC, which means it took 15 months to complete the investigation and lay charges, exceeding IMET's self-imposed 12 month guideline on completing investigations.

If it turns out that IMET significantly exceeds its own guidelines on a large number of its investigations, appropriate policy changes should be made. IMET could simply adjust its guideline upwards to 15 months or 18 months, for example, but such a change would be counter-intuitive, particularly because public perceptions about enforcement effectiveness are very much tied to the length of time that it takes to bring a matter to resolution. An alternative approach would be for IMET to pursue fewer files so that there are more resources available for each file. However, given that 33 files are currently being investigated by IMET, of which only 7 are active, there is not much room left to reduce the number of files. The most viable alternative may be to increase the resources available to IMET so that it can better meet its guidelines and complete investigations in a timely manner, if it in fact turns out that it is regularly exceeding its own guidelines.

IMET claims that it has a unique approach to enforcement in that it targets individuals as opposed to corporate entities. Superintendent John Sliter, Director of IMET, stated: "We take a different approach [than] some other enforcement units in other countries, who may tend to go after the whole company. We concentrate more on individuals."²⁴ Part of the rationale for targeting individuals in the context of criminal investigations may be because of the historic difficulty in attaching criminal liability to the corporate entity. Another rationale is that individuals who are convicted of criminal offences can be imprisoned whereas organizations cannot; they are generally only fined. An area worthy of further study and policy analysis would be whether targeting individuals or organizations in criminal and regulatory proceedings leads to better deterrence and more effective enforcement overall.

²⁰ "Police report 33 current investigations into Canadian financial crimes", Canadian Press NewsWire May 18, 2005.

²¹ Investment News, *supra* note 17.

²² "RCMP to follow up on alleged tainted investigations at ASC," Globe and Mail, November 26, 2005.

²³ See Former Betacom Executives Charged With Accounting Fraud. Available at: http://www.rcmp-grc.gc.ca/on/press/2005/2005_jun_14b_e.htm (Last accessed November 25, 2005).

²⁴ *Supra* note 17.

Along with creating IMET, the federal government also introduced significant legislative changes to the *Criminal Code*. Bill C-13 creates new *Criminal Code* offences of improper insider trading and whistle-blower retaliation.²⁵ Insider trading was previously an offence contained only in provincial securities laws. Bill C-13 also provides greater investigative powers for law enforcement agencies to compel documents from third parties. It also increases maximum penalties for existing fraud offences from 10 years to 14 years and provides greater guidance for judges at the sentencing stage.

Do the creation of IMET and the amendments to the *Criminal Code* mean that the percentage of criminal prosecutions will or should increase significantly? In my view, we should ensure that the proportions do *not* increase significantly. Based on the regulatory pyramid theory, the threat or possibility of criminal sanctions has sufficient deterrent value for most offenders and frequent resort to the criminal law will not be required.

There are also some practical and pragmatic reasons as to why the criminal law should be reserved for the exceptional case. The burden of proof beyond a reasonable doubt in the criminal context is much higher than the burden required under, for example, an administrative hearing pursued by a securities commission. As well, significant constitutional rights are triggered in criminal investigations and proceedings, and it is much more onerous to gather evidence and make a case in court relative to a regulatory proceeding. The recent developments discussed above should allow the small portion of cases that are selected to be investigated and prosecuted through the criminal route to be more successful.

(ii) Judges and Sanctions

As discussed above, the criminal law is at the apex of the regulatory pyramid. Criminal law sanctions should be considered when the regulated market participant has acted with intent or in bad faith. If a criminal conviction is obtained, the sanction imposed by the courts should reflect the severity of the misconduct and fact that the criminal channel was used as a last resort.

Historically, however, sanctions imposed by judges on corporate and capital markets offenders have been disappointingly light. They are often nominal fines that can be written off by the offenders as a cost of doing business. Existing studies reveal that white collar offenders are less likely to be imprisoned, receive lower average sentences and serve less time than offenders in relation to traditional crimes.²⁶

²⁵ An Act to Amend the *Criminal Code* (Capital Markets Fraud and Evidence Gathering) Third Session, Thirty-Seventh Parliament, 52-53 Elizabeth II, 2004. (Bill C-13).

²⁶ See for example, Criminal Corporation, *supra* note 16, at 621. See also Laureen Snider, “Abusing Corporate Power: The Death of a Concept” in S.C.Boyd, D.E. Chunn & R. Menzies, eds., [Ab]using Corporate Power: The Canadian Experience (Halifax: Fernwood, 2001). See also D.D. Graham Reynolds, “Observations on Sentencing in ‘White Collar’ and ‘Blue Collar’ Fraud Cases” (Federal Prosecutors’ Conference, Toronto, August 1994)(Unpublished) as cited in Puri, *supra* note 16 at 621.

There is a general perception among the public, including members of the judiciary, that capital markets misconduct is victimless and that financial crimes are not as serious as other criminal offences that cause physical harm.²⁷ The reality is that corporate and white collar crime is not victimless. The harms caused by corporate misconduct can result in substantial injury to a broad range of stakeholders, as witnessed by the recent corporate governance scandals and accounting frauds.

The Canadian judiciary needs to recognize not only the magnitude and impact of corporate misconduct on large segments of the population, but also the broader ramifications of corporate crime on the Canadian economy. At the sentencing stage, judges also need to better understand and apply economic theory in determining the appropriate sanctions for corporate offenders. Judges need to better understand the expected cost-benefit model of economic wrongdoing and impose fines that better approximate the benefit of non-compliance.²⁸ Fines need to be large enough that it should be a net loss for wrongdoers to engage in wrongdoing.

Assume that a company gains \$100 by non-compliance with a statutory provision. In light of scarce public resources, we cannot realistically expect to detect and prosecute all corporate misconduct, so assume that the probability of enforcement is 25%, such that one out of every four acts of this violation is detected and successfully prosecuted. If the company is convicted of the offence and a judge imposes a fine of \$100, it still remains profitable for the company to engage in this misconduct in the future. In fact, for every four times the company engages in the misconduct, it would gain \$400 but only pay out a fine of \$100. This simple example illustrates that fines need to be large enough to make it a net loss for wrongdoers to engage in misconduct, but this has generally not been the approach taken by the judiciary in setting fines.²⁹

In addition to fines, more creative sanctions such as probation orders, remedial orders, forfeiture and administrative penalties need to be considered and used more frequently. Judges should also consider longer imprisonment terms for individuals convicted of capital markets misconduct to enhance the general deterrent value of their sanctions.

Canadian judges currently have wide discretion at the sentencing stage. U.S.-style sentencing guidelines could remove much of the latitude that judges have at the sentencing stage. However, a more appropriate approach, in my view, would be to provide more guidance to judges about the factors that are relevant at sentencing in corporate and white collar crime cases, combined with greater judicial education and training sensitizing them to the relevant issues. Bill C-13 does, in fact, provide additional

²⁷ See for example, T.David Evans, Francis Cullen and Paula Dubeck, “Chapter 4: Public Perceptions of Corporate Crime” in *Understanding Corporate Criminality* (New York: Garland Publishing Inc., 1993).

²⁸ See, *Criminal Corporation*, *supra* note 16.

²⁹ See, *Criminal Corporation*, *supra* note 16.

guidance to judges on sentencing by reminding them that they have the discretion to impose harsher sentences in the presence of specified aggravating factors, including:³⁰

- (a) The value of the fraud committed exceeded one million dollars;
- (b) The offence adversely affected, or had the potential to adversely affect, the stability of the Canadian economy or financial system or any financial market in Canada or investor confidence in such a financial market; a fraud exceeding \$1 million, or if the offence adversely affects investor confidence or the stability of the Canadian economy;
- (c) The offence involved a large number of victims; or
- (d) In committing the offence, the offender took advantage of the high regard in which the offender was held in the community.

However, it is unlikely that many Canadian judges have the expertise to determine whether an offence adversely affects investor confidence or the stability of the Canadian economy. In our system of criminal justice, much of the responsibility for ensuring that judges can meaningfully interpret and apply relevant provisions lies on the prosecutors and defence lawyers who appear before the courts, and there may be a need for expert witnesses to be called to speak to these issues. However, it is also critical that judges receive broader context training and education that allows them to better appreciate the nature of corporate wrongdoing and its deleterious effect on investors as well as other stakeholders and the economy. Bodies such as the National Judicial Institute and the Canadian Institute for the Administration of Justice are well positioned to make available seminars and training workshops on corporate and white collar crime.

Serious consideration should also be given to developing specialized courts to deal with capital markets offences. Given that the criminal route should be used in a very small portion of cases involving corporate misconduct, it may be very efficient and effective for a small group of judges to develop and nurture a specialized expertise in hearing cases involving corporate and white collar crime offenders.³¹ There is certainly precedent in Canada for criminal courts dedicated to particular types of offences or groups of offenders. These include Youth Courts³² and Specialized Drug Treatment Courts Program.³³ Outside of the criminal context, some provinces have established specialized family courts at the superior court level to deal exclusively with certain

³⁰ Bill C-13, section 380.1(1)(a)-(d).

³¹ See also submission of Joe Oliver, President of the IDA, to the Legislative Assembly of Ontario, First Session, 38th Parliament, Official Report of Debates (Hansard) (Wednesday 18 August 2004) Page F-928.

The IDA also believes there is inadequate enforcement of criminal laws that deal with corporate and white collar fraud. We simply cannot allow Canada to acquire a reputation as a haven for white-collar crime. That is why we identified the need for dedicated criminal courts for the prosecution of white-collar crimes.

³² See <http://canada.justice.gc.ca/en/dept/pub/trib/page3.html#specialized>. (Last accessed November 27, 2005).

³³ *Ibid.*

family law matters, including divorce and property claims.³⁴ The Commercial List in Ontario, although not a specialized court per se, has also been very successful.

The goals underlying recent federal government initiatives, including Bill C-13 and the creation of IMET, are much more likely to come to fruition if appropriate attention is paid to the critical role of judges at the sentencing stage in the criminal law process. The historic reluctance of securities commissions to pursue quasi-criminal sanctions through the courts should also be countered by a well-defined strategy that allows judges to better appreciate the nuances of capital markets misconduct and impose sentences that give sufficient consideration to the principle of general deterrence.³⁵

5. Structuring the Discretion of Enforcement Departments

At a general level, the enforcement departments of securities commissions, SROs and other regulators have quite similar structures. There are multiple sources of complaints, including those from members of the public, referrals from securities commissions, SROs, law enforcement agencies and other regulatory bodies, as well as internally generated complaints from within the entity. The complaints are summarized and additional preliminary documentation is obtained if necessary. The file is then: (i) moved along to investigation for further evidence collection; (ii) closed as no further action is warranted; or (iii) referred to another entity as appropriate.

In investigations, investigators locate additional documentation (that is either voluntarily produced or compelled if the regulator has statutory or contractual powers to do so) and witnesses, including those who may be the subject of the investigation, are interviewed. A decision is then made to (i) move the file to litigation; or (ii) close the file for insufficient evidence.

In litigation, the file is first prepared for (i) a settlement and if one is not forthcoming, then (ii) a contested hearing. Most matters settle but settlement agreements must be approved before the relevant securities commission or a hearing panel.

Clearly, not all complaints received can make it to litigation. Some files will simply not have sufficient evidence to move them forward so they must be closed. The more difficult and challenging issue is which file(s) should be chosen when there *is* enough evidence to move multiple files forward. How should regulators distinguish

³⁴ *Ibid.*

³⁵ In the Andrew Rankin insider trading case, the trial judge imposed a six month sentence. The OSC recently filed a Notice of Appeal arguing that the sentence is “demonstrably unfit” and that it does not give proper consideration to the principle of general deterrence. See, Press Release: OSC Appeals Sentence in the Andrew Rankin Matter, November 25, 2005, available at http://www.osc.gov.on.ca/About/NewsReleases/2005/nr_20051125_osc-rankina.jsp. See also Notice of Appeal, available at http://www.osc.gov.on.ca/Enforcement/Proceedings/2005/rad_20051125_rankina.pdf (Last accessed November 27, 2005).

between different types of misconduct, issuers and registrants, and different types and amounts of harm caused?

Given limited resources, securities regulators need to structure the broad discretion that has been afforded to them so that they have a principled, rational and justifiable basis on which they pursue their enforcement agendas and activities. The recent events at the Alberta Securities Commission underscore the need for a disciplined enforcement system that has clear enforcement policies, guidelines and standards, as well as consistency in enforcement processes and appropriate analysis and reasoning to support conclusions and recommendations on files.³⁶

Regulatory bodies worldwide are moving towards risk-based regulation.³⁷ Depending on the regulator in question, factors that may be relevant in targeting certain market participants over others include the size of the regulated market participant, previous violations, whether or not the market participant has internal compliance systems in place, the capital base of the firm, and the experience and ability of management.³⁸

The OSC has publicly released a Staff Notice outlining its risk-based approach to enforcement.³⁹ The OSC has indicated that, as a general matter, it will pursue those matters that cause the “greatest harm to the integrity of Ontario’s capital markets taking into account successful resolution and resources required to achieve such an outcome.”⁴⁰

The theme of resources appears to be central to the risk-based approach outlined by the OSC. In deciding whether to pursue a matter, the regulator will consider the quantum of resources required to achieve a successful outcome and whether few additional resources would be required to bring the matter to a successful resolution. A factor suggesting that the regulator should not take jurisdiction is where “an extraordinary commitment of resources would be required, disproportionate to the conduct in question,”⁴¹ the Commission is less likely to pursue enforcement action against such a matter. Unlike in other regulatory contexts, regulated market participants in the capital markets may very well have resources that match or outdo the regulator in responding to a possible enforcement action, and as such, consideration of this factor in an individual

³⁶ See Report of the Auditor General on the Alberta Securities Commission’s Enforcement System (October 2005). Available at: <http://www.oag.ab.ca/html/Report%20of%20the%20AG%20on%20ASC%20enforcement%20systems.pdf> (last accessed November 27, 2005).

³⁷ OECD Report, *supra* note 1.

³⁸ *Ibid.*

³⁹ OSC Staff Notice 11-719, A Risk Based Approach for More Effective Regulation (2002), 25 OSCB 8410. See also Susan Wolburgh Jenah, A Risk-Based Approach to Securities Regulation, COSRA Meeting (August 31 – September 2, 2005) available at: <http://www.supervalores.gov.co/seminarios/RISK%20BASED%20APPROACH%20-OSC.pdf>. (Last accessed November 27, 2005).

⁴⁰ OECD Report, *supra* note 1.

⁴¹ *Ibid.*

case is sensible. However, if factors relating to resources are determinative in declining the pursuit of a large number of cases, all else being equal, this may indicate a systemic problem in the under-funding of the enforcement division and may suggest that more resources should be allocated to the enforcement branch of the regulator. In addition, the issue of comparative resources as between the regulator and the respondent, all else being equal, may lead to an unfair or disproportionate number of enforcement actions against smaller firms as opposed to larger ones.⁴²

Another theme that underlies many of the factors in the OSC's risk-based approach relates to the current divided and overlapping jurisdiction of multiple regulators in Canada. For example, if Ontario is not the primary jurisdiction where the misconduct took place or harm was felt, or if the misconduct involves potential criminal activity, the OSC Staff Notice states that enforcement staff is less likely to take jurisdiction.⁴³ In light of the existing structure of enforcement, these considerations as a matter of principle appear to be sensible; how they are played out in practice is even more important. Cooperation, co-ordination and issues surrounding deferring to other jurisdictions are discussed in more detail in Part 6 below.

Another theme that emerges from the OSC's risk-based enforcement strategy relates to the characterization of the regulator's role as one focused on forward-looking behaviour. The Staff Notice states that the "deterrence value of pursuing enforcement action" should be considered and the availability of "appropriate alternative remedies" is a diminishing factor.⁴⁴ As explored in Part 2 above, the appropriate issue of the role of the regulator appears to be at the heart of the contemporary debate on enforcement and to the extent that the securities regulator's role is re-conceptualized at the margins to have a greater focus on compensation for investors, the factors contained in the Staff Notice may need to be reassessed and reprioritized.

To the extent that other regulators have not done so, they should be encouraged to create, justify and publicly disclose the factors that they take into account in deciding whether they pursue enforcement actions.⁴⁵ This will allow for greater accountability and

⁴² This is a theoretical assertion that would need to be tested empirically. In addition to the issue of comparative resources, smaller market participants may also not have the capacity or the expertise to comply with legal rules, even if they are well intentioned, adding to the argument that they may be unfair targets of a risk based regulatory approach. While most large organizations have sophisticated internal compliance departments, smaller firms often lack the economies of scale to implement compliance programs. While this is outside the scope of an enforcement department of a regulator, regulators should help to build capacity in regulated market participants to be able to comply with the relevant legal rules by offering or making available the necessary education and assistance.

⁴³ OECD Report, *supra* note 1.

⁴⁴ *Ibid.*

⁴⁵ IMET also has a risk-based approach to regulation, although it does not appear to publicly disclose the relevant factors. "Any referred case is given a weighted score based upon a set of criteria that ensures that the most important cases relating to our investigative mandate receive the attention and resources they deserve. Cases with higher scores are more likely to be selected and investigated." See http://www.rcmp.ca/fio/imets-faq_e.htm. (Last accessed November 27, 2005).

transparency and better justification as to why a regulator did or did not take enforcement action on any particular file.

In addition, regulators should continuously assess current risk factors to ensure their relevancy. While the marketplace is generally a step or two ahead of regulators in terms of devising new products, structures and transactions, regulators cannot lag too far behind in respect of rule-making or enforcement. In this regard, the SEC has recently created an emerging risks department to remain current on new market products and trends and related risks.⁴⁶

This part of the paper uses the risk-based regulatory approach to analyze some important issues related to structuring of discretion and decision-making processes of securities regulators. There are other regulatory policies and practices – such as policies that credit regulated market participants for self-policing, self-correcting and self-reporting – that should be examined and analyzed to determine if they are meeting their intended policy objectives and whether they are having deleterious effects on regulated market participants and/or investors.⁴⁷

6. The Current Regulatory Structure: Issues Arising from Overlapping and Concurrent Jurisdiction

Effective enforcement requires significant co-ordination, co-operation and harmonization given the significant overlap in the current regulatory structure in Canada. The current regulatory structure with multiple securities commissions may increase the levels of non-compliance by regulated market participants. It may also impose unnecessary costs and/or unfairness on investors and regulated market participants. In this regard, the Wise Persons Committee Report stated:⁴⁸

We believe that inadequate enforcement is one of the most significant weaknesses of the current system. Enforcement

⁴⁶ See Testimony Concerning SEC's Mutual Fund Oversight Before the U.S. House Subcommittee on Commercial and Administrative Law by Lori A. Richards, Director, Office of Compliance Inspections and Examinations, U.S. Securities & Exchange Commission. Available at: <http://www.sec.gov/news/testimony/ts060705lar.htm> (Last accessed: November 27, 2005).

⁴⁷ For example, it may be appropriate for a regulator to reduce the sanction that would otherwise be imposed or apply no sanction at all in the context of regulated market participants who have detected non-compliance, are willing to disclose it to the regulator and take immediate corrective action. Internal compliance systems allow for self-policing, self-correcting and self-reporting can significantly reduce the burden on the regulator. If internal detection and reporting to the regulator are not somehow rewarded, then regulated market participants are likely to have less of an incentive to expend resources on such programs. However, such policies may also be considered to be unfair or coercive in some instances. See OSC Policy on Credit for Co-operation at: http://www.osc.gov.on.ca/About/NewsReleases/2002/nr_20020409_osc-hinke.jsp (Last accessed November 27, 2005).

⁴⁸ It's Time, WPC Final Report (December 2003) at 30. Available at: http://www.wise-averties.ca/finalreport_en.html . (Last accessed November 27, 2005).

resources are inefficiently allocated. Coordination difficulties can impede investigations and result in a multiplicity of proceedings, leading to further inefficiencies and potential injustices to respondents. Investor protection suffers from a lack of uniformity. There is no legitimate reason why investors should have different protection depending on the province in which they happen to live.

The current regulatory structure raises a number of important issues in relation to regulatory jurisdiction and the appropriate body to engage in any particular enforcement activity. For example, when should one provincial securities commission defer to another in terms of an investigation or hearing? When should there be joint hearings or investigations? When should the IDA or another SRO engage in enforcement activity and when should a securities commission instead pursue the matter? When should trading on inside information be labelled criminal and pursued as a charge under the *Criminal Code* and when should it instead be pursued by a securities commission as a quasi-criminal offence?

(i) Coordination Costs

There is a relatively high level of co-operation, co-ordination and communication amongst the various regulators involved.⁴⁹ The data show that there are a high number of referrals to other entities and concurrent or joint investigations occur relatively infrequently.⁵⁰ For example, the SSC reported that 25% of their investigations were referred to an SRO. The OSC referred a total of 31 files to other entities in 2002. Twenty-one of those 31 files were referred to another commission. One went to the IDA and 9 went to “other” regulatory agencies and law enforcement bodies.⁵¹

In terms of concurrent and joint investigations, only 2% of all RS investigations were concurrent with the IDA and less than 7% were concurrent with the OSC.⁵² This data suggest less conflict and turf-battling than one might initially think. It appears that regulators are willing to give up jurisdiction to another entity that is somehow more closely connected, based on issuer location, investor location, or expertise.

This general picture of co-operation does not appear to be as true in the context of high profile cases, such as Yorkton or Cartaway, where it is less likely that a commission or SRO will completely defer to another entity and step out of the matter

⁴⁹ *Charles River Associates, Securities Enforcement in Canada: The Effect of Multiple Regulators, study prepared for the Wise Persons' Committee (December 2003)*. Available at: http://www.wise-averties.ca/report_en.html (Last accessed November 27, 2005) [CRA Study].

⁵⁰ *Ibid.*

⁵¹ *Ibid.*

⁵² *Ibid.*

entirely.⁵³ In high profile cases, it is more likely that the regulators will divide up the issues or appoint a lead regulator. Regulators may also engage in joint investigations and hearings where no lead regulator clearly emerges.

Each of these possibilities increases co-ordination costs and time and expense for market participants as well as overall costs for regulators.⁵⁴ For example, in the context of a lead commission, settlement discussions and agreements need not only the approval of the lead regulator but all the other regulators who are involved, which may or may not be forthcoming. Lawyers representing respondents have to spend additional time and resources co-ordinating with the various regulators involved. Similarly, partitioning cases into components among two or more commissions, a stock exchange and/or IDA may not always be justified and could be better achieved through one regulator pursuing a case.⁵⁵

The costs of co-ordination as between provincial securities commissions could be reduced through a consolidated regulator, as there would no longer be a need to appoint a lead regulator or joint matters. However, co-ordination costs would not be entirely eliminated because decisions still need to be made about whether a matter is appropriately within the jurisdiction of a securities commission (under a consolidated regulator or the current system), an SRO, or criminal law enforcement agencies. Co-ordination costs in respect of the SROs could be reduced if the IDA, RS and the MFDA merge, as was recently tabled for discussion.⁵⁶

What is becoming even more important than co-ordination and co-operation among Canadian regulators is the issue of international co-operation and co-ordination as between Canadian regulators and foreign counterparts, particularly U.S. regulators. The policy implications of requests for assistance from other foreign jurisdictions as well as the technical issues for regulated market participants who are under investigation in Canada as well as other jurisdictions internationally should be the subject of further study.⁵⁷

(ii) Effectiveness of Remedies

⁵³ *Ibid.*

⁵⁴ *Ibid.*

⁵⁵ *Ibid.*

⁵⁶ Teresa Tedesco, "Mutual fund body rejects link with IDA: 'Not in the public interest'", Financial Post, November 16, 2005.

⁵⁷ See, for example, David Brown, The 3 Cs for Improving Securities Law Enforcement: Coordination, Cooperation and Communication, Financial Services & Public Policy Conference, Schulich School of Business, York University, April 23, 2004. Available at http://www.osc.gov.on.ca/About/Speeches/sp_20040423_db-3cs-security-law.jsp. (Last accessed November 27, 2005).

The range of sanctions and the maximum fines vary from province to province, which creates unfairness for both investors and respondents,⁵⁸ but equally as significant is that a sanction ordered by a provincial securities commission is only effective in the province in which it was ordered. For example, assume that the ASC takes jurisdiction over a particular matter of misconduct and no other commission does. Assume also that the sanction ordered under the regulator's public interest power is a ban on being a director or officer of a company for 10 years. Under the current system, there is nothing to prevent the sanctioned individual from going to BC or Ontario and becoming a director or officer of a public company there. This is extremely problematic from an enforcement policy perspective, particularly in the context of investor protection. If a regulator has decided that it is not in the public interest that an individual who has engaged in misconduct be a director or officer in Alberta, for the benefit of Alberta investors and residents, other Canadian investors should have the benefit of the same protection.

(iii) Differences in Enforcement Policies and Priorities

a. Actual Differences in Types of Cases that Get Pursued

There are significant differences amongst the commissions in respect of the types of cases that get pursued for enforcement as well as the factors that are considered relevant in sanctioning. There are also significant differences in enforcement trends among commissions. The OSC, for example, is focused on registrant-related misconduct, while B.C. has focused its enforcement efforts on the distribution of securities without a prospectus.⁵⁹

What types of cases get pursued for enforcement is an important and interesting issue. In part, it is the result of the types of complaints received from the public and referrals made by other regulators. In part, it is a top-down exercise of priority setting by the relevant commission. For example, the Ontario Commission has made the prosecution of insider trading cases a priority.⁶⁰ It may also be related to perceptions about the different nature of the local markets across the country. There is a perception that the BC market is different than the Ontario market. The perception is that BC is dominated by promoters and junior resource companies attempting to raise financing and, as a result, the regulator may be pressured to focus enforcement activities on misconduct in this sphere.⁶¹ Alternatively, it may be that the OSC takes jurisdiction over most of the

⁵⁸ Mary Condon, *The Use of Public Interest Enforcement Orders by Securities Regulators in Canada* (WPC Research Study 2003) Available at: http://www.wise-averties.ca/report_en.html (Last accessed November 27, 2005) [Condon Study].

⁵⁹ *Ibid.*

⁶⁰ David Brown, *The 3 Cs for Improving Securities Law Enforcement: Coordination, Cooperation and Communication*, Financial Services & Public Policy Conference, Schulich School of Business, York University, April 23, 2004. Available at http://www.osc.gov.on.ca/About/Speeches/sp_20040423_db-3cs-security-law.jsp (Last accessed November 27, 2005).

⁶¹ See Condon Study, *supra* note 58. See also, Poonam Puri, *Local and Regional Interests in the Debate on Optimal Securities Regulatory Structure* (WPC Research Study 2003) Available at: http://www.wise-averties.ca/report_en.html. (Last accessed November 27, 2005).

nationally regulated market participants, and as a result, other provincial commissions then take on enforcement matters that are more local in nature or intra-provincial. While this last factor in particular may help to shed some light on the differences in enforcement trends across the country, it also highlights that the combined enforcement actions of multiple provincial regulators may lead to sub-optimal enforcement in contrast to a national or consolidated regulator which could pursue an enforcement agenda that would better reflect the national interest.

b. Local Differences in Sanctioning Principles

The provincial commissions also appear to have different approaches regarding the factors that are relevant to sentencing. One issue is whether the consequences to the respondent of the proposed sanction and its quantum should be taken into account.⁶² Some commissions, such as the ASC, have taken the position that this factor should not be taken into consideration in sanctioning. Other commissions, such as Saskatchewan, Manitoba, Ontario and New Brunswick, have indicated that they are willing to consider and give some weight to the impact on the respondent in choosing the sanction and setting the quantum.⁶³ The BCSC has decisions that go both ways.⁶⁴

If the focus is on general deterrence as the primary goal of enforcement, one could make the argument that little or no weight should be given to the respondent's particular circumstances. However, to the extent that we are also interested in specific deterrence and changing the future behaviour of the particular person that is being sanctioned, it is entirely reasonable to consider the impact on the respondent, particularly where it may create unfairness or undue hardship. The relevance of this factor may also differ depending on whether the respondent is an individual or a corporation. While a thorough analysis on this issue is beyond the scope of this paper, and reasonable people may disagree on whether this factor should weigh into a sentencing decision, this is an important policy issue on which there should be greater certainty, clarity and consistency for respondents. More generally, CSA members should agree on a set of sanctioning principles and guidelines.

7. Measuring and Comparing Enforcement Effectiveness

(i) Canadian Data on Enforcement Activity and Outcomes

Most securities regulatory bodies collect data that measure their enforcement activity by way of inputs such as enforcement budgets and enforcement staff and outputs such as number of cases opened and closed, number of active files, time to complete

⁶² Condon Study, *supra* note 58.

⁶³ *Ibid.*

⁶⁴ *Ibid.*

investigations or hearings,⁶⁵ and sanctions imposed. These data are relatively easy to collect and measure.

Recently, Canadian securities regulatory bodies have been making much more of an effort to communicate such information to the public. For example, the CSA released its first Report on Enforcement Activity (from April 1 to September 30, 2004) highlighting that during the first six months of 2004, CSA members commenced 77 enforcement matters; fifty-nine cases resulted in sanctioning orders or settlements during that time period.⁶⁶ In its second report on enforcement (from October 1, 2004 to March 31, 2005), the CSA reports that members commenced 65 new proceedings and settled or ordered sanctions in 88 matters.⁶⁷ The CSA reports also contain data about the enforcement activities of the SROs.

On the issue of enforcement budgets, in 2002 Ontario's enforcement budget was just over \$9 million, with Quebec following at \$4.4, B.C. at \$3.5 and Alberta at \$3.1.⁶⁸ Examining enforcement budgets as a percentage of total budgets, the commissions spend between 10 to 20% of their total budgets on enforcement.⁶⁹ It is noteworthy that Ontario and Quebec have significantly increased their enforcement resources, as measured by the number of enforcement staff.⁷⁰ The OSC has more than doubled its enforcement staff (from 38 in 1998 to over 90 in 2005).⁷¹ Even though the OSC has increased its resources, the number of hearings does not appear to have increased over this time period; in fact, it appears that the number of hearings has stayed consistent at around 30 between 2002 and 2005.⁷² This suggests that the OSC is deploying additional resources per file pursued, keeping the number of files constant, as opposed to using the additional resources to increase volume by opening new files.

While it is extremely important that regulatory agencies communicate their enforcement activities and data to the public, the data that is currently collected and released is insufficient to draw complete and meaningful conclusions about the *effectiveness* of enforcement activities and programs undertaken by regulators.⁷³

⁶⁵ See for example Notes for remarks by David A. Brown, "A Cooperative Approach to Fighting Economic Crime" PriceWaterhouseCoopers May 27, 2004 at 6.

⁶⁶ Canadian Securities Administrators, Report on Enforcement Activities from April 1, 2004 to September 31, 2004. Available at: http://www.csa-acvm.ca/pdfs/Enforcement2004_Eng.pdf (Last accessed November 27, 2005).

⁶⁷ Canadian Securities Administrators, Report on Enforcement Activities from October 1, 2004 to March 31, 2005. Available at: http://www.csa-acvm.ca/pdfs/Enforcement-Report_Oct-Mar2005_Eng.pdf (Last accessed November 27, 2005).

⁶⁸ CRA Study, *supra* note 49, Table 3.

⁶⁹ *Ibid.*

⁷⁰ *Ibid.*

⁷¹ Ontario Securities Commission 2005 Annual Report at 3. Available at: http://www.osc.gov.on.ca/About/AnnualRpt/rpt_2005-osc-en.pdf . (Last accessed November 27, 2005)

⁷² *Ibid* at 6.

⁷³ OECD Report, *supra* note 1.

If more cases are opened, closed, or settled over previous years, is enforcement any more effective? It may be that simpler or more complex matters were taken on. If fines imposed are higher than in previous years, is enforcement more effective? If a larger number of insider trading cases are opened in any particular year, does it necessarily mean that more improper insider trading was taking place in the capital markets, or does it reflect a policy priority of a securities commission to focus its enforcement resources on this particular offence?

Given that a central goal of enforcement activity is deterrence, the most useful data to assess the effectiveness of enforcement activity has to do with its impact on the actual behaviour of regulated market participants. Did the enforcement activities actually have a discernable impact on the behaviour of regulated market participants and the underlying policy objectives of securities regulation? It is acknowledged that these data are more difficult to collect, measure and analyze but greater attempts should be made by regulators to do so.⁷⁴

(ii) Comparative Enforcement Activity and Effectiveness

When discussing issues of enforcement, the assertion is inevitably made that Canada does not engage in enough enforcement activity relative to the U.S. and that Canadian regulators are less effective at enforcement. For example, the Wise Persons Committee reported: “There is a widely held view that enforcement in Canada is lax in comparison with the United States and other countries.”⁷⁵ David Dodge, the Governor of the Bank of Canada, also made a bold statement in late 2004 about the Canadian state of enforcement:⁷⁶

This is a very common refrain we hear when we visit markets in New York or in Boston or in London or in Europe, a perception that, somehow, this is kind of a little bit more of a Wild West up here in terms of the degree in which rules and regulations are enforced -- and that perception doesn't really help us when we go to try to raise money on foreign markets.

Investor perceptions about relative enforcement effectiveness are important and needs to be addressed, particularly in light of the increased mobility of capital in today's global economy. However, care needs to be taken to ensure that we are cognizant of structural, legal and practical differences between jurisdictions and differences in regulatory authority amongst regulators that may account for different levels of enforcement activity.

⁷⁴ See also CRA Study, *supra* note 49 at footnote 12.

⁷⁵ *Supra* note 48.

⁷⁶ “Canada like 'Wild West': Dodge: Calls for crime crackdown, ruling on bank mergers” National Post, December 10, 2004.

In comparing U.S. data with Canadian data, Canadian commissions devote a smaller percentage of their total budget to enforcement than comparable U.S. commissions.⁷⁷ The CRA study commissioned for the Wise Persons Committee found that the U.S. SEC's enforcement budget is 29% of its total budget while enforcement accounts for between 13% and 19% of the budgets of the commissions in BC, Alberta, Quebec and Ontario.⁷⁸

This comparison begs the question of the relationship between enforcement effectiveness and resources. Certainly no resources dedicated to enforcement means no enforcement activity can take place, but does doubling enforcement resources or increasing the percentage of a commission's total budget mean that enforcement will be more effective? The relationship between resources and enforcement effectiveness is not linear, but certainly more resources can allow for either a greater volume of cases to be pursued and/or for additional resources to be devoted to each file.

In comparing enforcement budgets, one also needs to take into account a holistic picture of the reasons for non-compliance by regulated market participants. Resources in a commission need to be divided up between policy-making, enforcement and various other departments. As between two regulators, it may be that the similar level of compliance can be achieved by a different allocation of resources between various departments. For example, one regulator may devote more resources to policy-making by spending more time and effort at the rule design stage, with more extensive consultations with stakeholders, and with greater analysis and thought about the appropriate form and tools of regulation; another commission may spend proportionately less resources at the rule design stage and expend much greater resources at the later stage of enforcement to ensure compliance with the rules. However, the level of compliance with the legal rules by market participants regulated by both regulators may end up being similar.

Comparisons are also frequently made on the quantum of monetary penalties imposed by Canadian regulators compared to U.S. regulators. Canadian regulators are criticized that the level of fines imposed on wrongdoers are substantially less than by the U.S. SEC. The CRA study found that fines and administrative penalties are actually comparable between Canada and the U.S. securities regulators.⁷⁹ However, total monetary penalties are higher in the U.S. than in Canada. In particular, "U.S. monetary penalties are ten times larger than average Canadian penalties, per Canadian \$10 billion GDP" when account is taken of SEC civil penalties and disgorgements of illegal profits along with U.S. state restitution.⁸⁰ It also found that total penalties are higher in the U.S. as a result of large restitution powers.⁸¹

⁷⁷ CRA Study, *supra* note 49.

⁷⁸ See Wise Persons Committee Report, *supra* note 48 at 27. See also CRA Study, *supra* note 49.

⁷⁹ CRA Study, *supra* note 49 at Table 8.

⁸⁰ *Ibid.*

⁸¹ CRA Study, *supra* note 49 at Table 8.

Do these data indicate that enforcement is more lax in Canada than the U.S.? There are several factors that need to be taken into account in comparing the data. First, some Canadian commissions do not have the full range of remedies that are available to the SEC. Many Canadian securities commissions do not have powers of restitution, disgorgement, or administrative sanctions.⁸² Second, the maximum administrative penalty that can be imposed by Canadian commissions that do have such power varies significantly from a low of \$100,000 in Saskatchewan and Nova Scotia to a high of \$5 million in Manitoba for corporations.⁸³ Third, some Canadian securities commissions were only recently granted additional statutory authority in respect of the types of powers they have and the orders they can make and so there is likely to be lag in respect of actual usage.⁸⁴

Another significant difference in enforcement policy and practice between U.S. and Canadian regulators is that to settle matters, the SEC does not currently require an admission of guilt whereas Canadian regulators do. Under the U.S. system, respondents can settle but “neither admit nor deny” the relevant charges. All else being equal, this policy certainly increases the willingness of respondents to settle in the U.S. context and also favourably impacts – at least in terms of perceptions – the number of successful cases settled by the SEC. However, it is questionable as to whether such a policy actually achieves the underlying goals of enforcement, in particular behaviour modification of regulated market participants. As such, it is not advisable in my view for Canadian regulators to consider such a policy change solely in the interests of increasing the volume of “successful” settlements. Similarly, the frequent use of the “perp walk” in the U.S. is a practice that has been much less common in Canada and should not necessarily be encouraged. Finally, a number of the high profile cases in the U.S. that have caught the attention of the Canadian press and the Canadian public have not been pursued by the SEC but under the criminal law powers by the state Attorneys-General, most notably Eliot Spitzer.

The significant differences in statutory authority afforded to the different securities commissions highlighted above, as well as practical differences in the handling of cases, limits the extent to which complete and meaningful comparisons can be made between Canada and the U.S. securities regulators. To the extent that there are justifiable policy differences and approaches between Canada and the U.S., regulated market participants, investors and the general public should be made aware of them.

(iii) Canadian Regulatory Autonomy and Independence: Defer to the SEC for Canadian Inter-Listed Companies?

Warren Grover recently suggested that Canadian securities regulators should focus their enforcement activities on the sub-set of Canadian companies with no U.S. or international presence and allow the SEC to monitor and engage in enforcement against

⁸² See Condon Study, *supra* note 58.

⁸³ *Ibid.*

⁸⁴ *Ibid.*

Canadian inter-listed companies.⁸⁵ While this proposed approach would free up enforcement resources for Canadian regulators, I believe it is misguided. It would exclude from Canadian regulatory oversight large public companies – such as Nortel and Hollinger - in which many Canadian public investors have significant investments. While I appreciate that there is much functional convergence of securities law rules based on the rule making or enforcement actions taken by the SEC, the proposed approach would also undermine the regulatory independence and autonomy of Canadian regulators. On a more practical matter, there is the issue of jurisdictional reach and the impact of the sanctions imposed by the SEC. The SEC can sanction Canadian inter-listed companies but the sanctions are only effective in the U.S. and would not prevent the wrongdoers from engaging in the sanctioned conduct in Canada without some sort of action by Canadian securities regulators.

8. Conclusion

This study analyzed key issues related to enforcement effectiveness in the Canadian capital markets, and found that the effectiveness of regulatory enforcement by public regulators must be considered in the context of a comprehensive enforcement strategy which includes private enforcement mechanisms as well as investor education programs.

The study found that the time might be ripe to re-conceive of the role of the securities regulator in the 21st century as one that, in addition to taking enforcement actions on the basis of the principle of deterrence, also acts as a catalyst or facilitator to assist investors in receiving compensation for harms suffered.

The threat of a criminal prosecution can act as a real and significant deterrent to regulated market participants. It recommended that *Criminal Code* prosecutions be reserved for the most egregious cases of capital markets misconduct. The IMET strategy of expending significant resources on a very small number of investigations is reasonable in this context. The role of judges is critical in the criminal law process and to ensure that the goals underlying the creation of IMET come to fruition, judges should be provided with greater context-training and education on the harms caused by corporate and white collar crime. Serious consideration should also be given to the creation of specialized courts for capital markets misconduct.

Securities regulators need to structure the broad discretion that has been afforded to them so that they have a principled, rational and justifiable basis on which to pursue their enforcement agendas and activities. To the extent that some Canadian securities regulators have not done so already, they should be encouraged to create, justify and publicly disclose the factors that they take into account in deciding whether to pursue enforcement actions.

⁸⁵ Warren Grover, Corporate Governance of Greed, Falconbridge Lecture in Commercial Law, Osgoode Hall Law School (October 2004, on file with author).

Effective enforcement requires a high-level of co-operation, co-ordination and communication among Canadian securities regulators. The current regulatory structure would benefit from greater co-ordination and co-operation in relation to enforcement policy setting and priority-setting. A system should be devised to recognize sanctions imposed by one securities commission in other Canadian jurisdictions. Attention should also be paid to technical and policy issues related to co-operation and co-ordination with foreign counterparts, particularly regulators in the U.S.

While Canadian securities regulators should continue to collect and disseminate basic data on enforcement activities, greater effort should be made to *analyze* the impact of enforcement inputs and outputs on the actual behaviour of regulated market participants. Investor perceptions about Canada's enforcement effectiveness relative to other jurisdictions, in particular the U.S., are important and need to be addressed, particularly in light of the increased mobility of capital in today's global economy. In comparing Canadian and U.S. data on enforcement, one needs to be cognizant of differences in statutory authority afforded to the securities regulators as well as practical differences in the handling of cases. Canadian securities regulators should educate investors, the press and the public about these differences but at the same time consider adopting best practices and policies from other jurisdictions to the extent that they may enhance enforcement effectiveness in the Canadian capital markets.

