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The Role of Compliance in Securities Regulatory Enforcement

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Research Study

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Task Force to Modernize Securities Legislation in Canada**

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Professor Condon teaches Securities Regulation and Advanced Securities in Osgoode Hall Law School's LLB program and also directs and teaches in its part-time LLM program specializing in securities law. Professor Condon's research interests are focused primarily on the regulation of securities markets, investment funds, online investing, and pensions. She is a co-author (with Professor Anita Anand from Queens and Professor Janis Sarra from UBC) of *Securities Law in Canada: Cases and Commentary*, published by Emond Montgomery Publications in early 2005. Her book entitled *Making Disclosure: Ideas and Interests in Ontario Securities Regulation* was published by University of Toronto Press in 1998. She is also the author of articles, book chapters and commentaries on topics related to securities regulation and pensions policy, and has presented papers or given invited lectures at international conferences and universities. She has prepared policy papers for the Department of Finance (Wise Persons Committee) and the Law Commission of Canada and has recently completed a research project for the Task Force to Modernize Securities Regulation (with Professor Poonam Puri). She is also the principal investigator on two academic research projects: one dealing with on-line investing and the other with governance of pension funds and mutual funds. In 2006-7 she will be a Virtual Scholar in Residence at the Law Commission of Canada.

Professor Condon joined Osgoode Hall Law School's faculty in 1992, having received the Canada Law Book Alan Marks Medal for completing the best graduate thesis in 1991 at the University of Toronto, Faculty of Law. In addition to her research and teaching, Professor Condon has been Director of Osgoode's full-time Graduate Program in Law. She is a member of the Bar of Ontario.

Poonam Puri

Professor Puri is an Associate Professor of Law at Osgoode Hall Law School and Co-Research Director, together with Professor Paul Halpern, for the Task Force to Modernize Securities Regulation. Professor Puri's expertise lies in securities law, corporate law, corporate governance, and corporate and white-collar crime. She is a prolific scholar, having co-authored 3 books in 2004 alone, including Corporate Governance and Securities Regulation in the 21st Century (with J. Larsen); and Cases and Materials on Partnerships and Canadian Business Corporations (with D. Harris, R.Daniels, E.Iacobucci, I.Lee, J.MacIntosh, and J.Ziegel). She has also written over 25 major scholarly articles, book chapters and reports. Professor Puri was a Visiting Professor at Cornell Law School in 2000-2001 and is currently a Visiting Professor at the Rotman School of Management at the University of Toronto.

Professor Puri has been sought out by governments and regulators both in Canada and internationally, including Industry Canada, the Ontario Securities Commission, the Canadian Senate, the Wise Persons Committee on Securities Regulation and the International Finance Corporation of the World Bank. Her advisory work is known to be academically rigorous and firmly grounded in the real-time and complexities of policy making.

In 2005, Professor Puri was appointed a member of the OSC's newly created Investor Advisory Committee, providing input to the Commission on the concerns of retail investors. She is the President-Elect of the Canadian Law and Economics Association and will assume the presidency for the 2006-2008 period later this year. In 2006, she was named one of Canada's Top 40 under 40. Professor Puri is a graduate of the University of Toronto Faculty of Law (LL.B. Silver Medalist) and Harvard Law School (LL.M.). She articled at Torys and was a summer associate at Paul Weiss Rifkind Wharton and Garrisoin prior to joining the faculty at Osgoode Hall Law School.

Table of Contents

1. **Executive Summary**

This research study considers the strengths and limits of a compliance-based approach to the regulation of securities markets in Canada. The study analyses the viability of the compliance-based tools and strategies currently employed in four specific areas of investor and regulatory concern and makes recommendations for further development of the compliance-based approach to regulation.

Compliance is defined in this study as a regulatory style or set of specific strategies designed to enhance market integrity. It focuses on ways of encouraging market participants to abide by norms of securities laws by a combination of careful rule design as well as continued monitoring of market participants' actual practices. The approach assumes that market participants will abide by rules that they perceive to be legitimate. A summary of our specific recommendations is set out below.

2. <u>Summary of Recommendations</u>

Abusive Sales Practices

<u>Recommendation #1:</u> Securities Commissions and SROs should make greater efforts to educate investors about market risks and who should bear the risk of loss when investment losses are incurred in the marketplace. Greater education should also be provided on the importance of a diversified portfolio.

<u>Recommendation #2:</u> Financial advisors and their firms should be required to disclose the risk associated with any particular investment at the time that the transaction is entered into, in a manner that is easily understood, and the effect of the transaction on the client's overall portfolio in terms of risk and diversification.

<u>Recommendation #3:</u> At the time of account opening, firms and financial advisors should be required to disclose the following information in a brief (one- or two-page) document: (a) a list of compensation options for the services that will be provided (whether or not available at that firm); and (b) the particular compensation options available at the particular firm and by that advisor.

<u>Recommendation #4:</u> At the time of a particular transaction, the financial advisor should be required to disclose, in a transaction summary document, the total dollar value of compensation the investor has paid or is obligated to pay, directly or indirectly, to the advisor and his/her firm. Also to be disclosed would be any compensation and benefits that will be received by the financial advisor and the firm from third parties. Financial advisors should also be required to disclose the dollar value of the compensation that would have been paid by the client had he/she selected another compensation option for the relationship at the time of account opening, or another compensation method for the particular transaction.

<u>Recommendation #5:</u> At year end, financial advisors should be required to disclose the total fees paid by the client over the year as well as fees that would have been paid under other options.

<u>Recommendation #6:</u> Firms should be encouraged to impose higher standards of proficiency on their employees than those currently required by regulators, as a part of their business model to distinguish themselves from their competitors.

Recommendation #7: **Regulators should also consider imposing heightened proficiency requirements and professionalism standards that currently required, to imbue a greater sense of professionalism in the industry.**

Recommendation #8: **Regulators should mandate disclosure of the advisor's educational background and qualifications at the time of account opening, including any qualifications that are above and beyond minimum regulatory requirements.**

Recommendation #9: **Regulators should require advisors to disclose to new and existing clients any proven complaints of unsuitability and other abusive sales practices.**

Recommendation#10: **Regulators should require advisors to disclose proven claims of unsuitable investments and other abusive sales practices to new and existing clients.**

Recommendation#11: **The compliance approach should not be used for persistent and egregious offenders who continuously engage in abusive sales practices. Instead such offenders should be removed from the industry.**

Recommendation #12: **Regulators should be encouraged to obtain retail investor input on how the risk-based methodology for sales compliance audits is defined and what factors are considered relevant in determining which firms become the subject of such audits.**

Recommendation #13: **Firms should be encouraged to use a risk-based approach internally within their organizations to ensure that salespeople and branch offices are meeting the baselines expected of them and also to identify and deal with particular sales people and/or branch offices that are particularly troublesome in terms of the issue of abusive sales practices.**

Recommendation #14: **The IDA should be provided with statutory authority to compel third-party witnesses to appear before it in regulatory proceedings, so as to enhance the effectiveness of its enforcement proceedings.**

Insider Trading

Recommendation #15: **Regulators should mandate that all reporting issuers develop and file an explicit code of conduct dealing with prohibitions on insider trading and insider reporting policies.**

Recommendation #16: **The content of an IT policy should not be mandated by regulators, though it most likely should include the introduction of routine "blackout periods". It should also provide some indication of how the issuer proposes to monitor ongoing adherence to its internal policy.**

Recommendation #17: **RIs should be encouraged to include, as an element of their IT policy, an undertaking to make best efforts to inform RS of potential material changes that are reasonably likely to occur.**

Recommendation #18: **Issuers and registrants should better educate their officers and employees about the parameters of insider trading, such as when information is sufficiently "material" to trigger the insider trading prohibitions. Issuers should also engage seriously in an ethics-building process with respect to insider trading.**

Recommendation #19: **Issuers should give serious consideration to developing ongoing monitoring capabilities in the area of insider trading, especially with respect to the granting or exercise of stock options. This could include the appointment of a senior officer with responsibility for approving the exercise of stock options.**

Recommendation #20: **Additional regulatory resources should be devoted to the enhancement of technological tools for detecting or preventing insider trading activities.**

Recommendation #21: **Insider trading should be disclosed publicly in real time, as a further deterrent to illegal insider trading and to enhance the market information available to retail investors.**

Recommendation #22: **Regulators should adopt a risk-based approach to monitoring and surveilling RIs for compliance with enhanced insider trading requirements.**

Primary Market Disclosure

Recommendation #23: **A uniform definition of material fact should be adopted across the country in the interest of ensuring compliance with the prospectus requirements. The distinction between material fact and material change should be eliminated.**

Recommendation #24: **Regulators should engage in full or targeted review of only those prospectuses for which they are the issuer's principal regulator under MRRS, so as to expend their resources efficiently and avoid duplicative review.**

Recommendation #25: **In light of the liberalization of the short-form prospectus eligibility requirements, securities regulators should engage in more frequent and more in depth vetting of short-form prospectuses (and continuous disclosure records) of those issuers who are not as closely followed by market participants such as research analysts.**

Continuous Disclosure

Recommendation #26: **CD regulatory efforts should be refocused on reviewing internal control systems, as opposed to primarily reviewing the content of specific CD documents.**

Recommendation #27: **Regulators should enhance RI capabilities with respect to CD by developing a series of best practice templates for successful disclosure control and reporting systems, targeted to areas of persistent CD deficiency.**

Recommendation #28: **Enforcement sanctioning by regulators should routinely involve orders that RIs review their internal disclosure procedures and controls, with the additional requirement that the results of this review and the action to be taken be reported to the regulator.**

Recommendation #29: **Regulators should consider additional publicity concerning the existence and content of the *Reporting Issuers in Default* and *Refilings and Errors* lists that they maintain.**

<u>Recommendation #30:</u> Reporting issuers should be encouraged to participate in a number of disclosure-related innovations, such as (i) disclosure sub-committees of the board, (ii) the appointment of a disclosure compliance officer at senior management level (iii) enhanced disclosure in MD&A documents about the existence and nature of internal disclosure control systems.

Conclusion

<u>Recommendation #31:</u> Additional research should be sponsored to provide detailed calculation of the costs of compliance with external regulatory and internal self-regulatory initiatives, as well as its qualitative and quantifiable benefits.

Finally, we note that none of the compliance strategies used on its own will achieve the desired outcome; a comprehensive compliance strategy involves a mix of the various rule design, monitoring and incentive-based approaches.

3. <u>Introduction</u>

i. Objective of this Research Study

This study was commissioned by the Task Force to Modernize Securities Legislation in Canada (Task Force) under the auspices of its enforcement research theme. The goal of the project is to consider the strengths and limitations of a compliance-based approach to regulating significant aspects of securities markets operation in Canada. In doing this, the study considers the viability of specific compliance-based tools and strategies currently employed in securities markets and makes recommendations for further development of this approach to regulation. To lend some specificity to the analysis, the researchers have identified a number of central areas where investors and regulators are concerned about market participants' adherence to regulatory requirements. We then use a case study method to assess the role played by a compliance approach to regulation in each case, and make specific recommendations for further enhancement. The case studies developed in the body of the report are those of: (i) abusive sales practices; (ii) insider trading; (iii) primary market disclosure; and (iv) continuous disclosure.

ii. Definitional Issues

It is important to specify from the outset what we mean by a compliance approach to securities regulation, as the idea of compliance is used in a number of alternative ways in the literature on regulation. The idea can be used simply and descriptively to signal the extent of compliance or non-compliance by market participants with securities regulatory rules. More sociologically, it can refer to a set of values exhibited by individuals or firms that guide their behaviour, for example, references to so-called "cultures of compliance[1]".

Somewhere between these two ideas is the sense in which we use compliance in this study; that is, as a regulatory style or a set of specific strategies to achieve the desired regulatory outcomes.

The idea of compliance as a regulatory style has a number of components. In the first place, it tends to focus on ways of encouraging market participants to abide by norms of securities law by a combination of

[1] In so far as this report will address strategies for generating "cultures of compliance" within organizations, it will focus primarily on the contribution that legal rules and regulatory strategies can make to the development of such cultures, rather than the influences on organizations of broader sociological, anthropological or cultural factors. While these broader questions are fascinating, they are largely beyond the scope of this project. See Ronald B. Davis "Fox in SOX North, A Question of Fit: The Adoption of United States Market Solutions in Canada" [2004] Vol XXXIII *Stetson Law Review* 955 at 990.

careful rule design as well as continued monitoring of the extent to which market participants are in fact abiding by these rules. In this sense, compliance is often characterized - not entirely accurately - as a proactive rather than a reactive approach to regulation. It also tends to assume that market participants will abide by rules that they perceive to be legitimate and whose rationale is explained to them. In this sense, a compliance-based approach to regulation is often contrasted in the academic literature with a deterrence-based approach, which tends to assume that market actors will break the law if it is in their self-interest to do so, with the implication that what is necessary to prevent this from happening is rigorous sanctioning. More recently, a compliance orientation to regulation has focused on ways to embed compliance within organizational routines, as opposed to an emphasis on uncovering and punishing individual malfeasance, based on assumptions about the motivations of individual behaviour.

Given this brief description of a compliance orientation to regulation, it may immediately be noted that a study that purports to examine the feasibility and expansion of such an approach to regulation will involve a broader lens than examining enforcement practices per se, as it is the case that in many securities regulatory bodies, compliance activities are organizationally separated from enforcement activities. This is as true of the dominant self-regulatory organizations in Canada as it is of provincial regulators. In other words, a fuller sense of the strategies that may be useful to promote acceptable market behaviour will require a look beyond the activities of enforcement departments per se. It also suggests that an important component of the research should be an understanding of how, in practice, compliance departments within regulatory organizations interact with enforcement departments.

iii. The Case for Compliance

It is no secret that effective enforcement of securities regulation is an intensely debated topic in Canada, and North America more generally. So far, the predominant response of Canadian regulators has been to attempt to engage in, and demonstrate, an increasingly punitive style of enforcement. This has been reflected in legislative changes to the *Criminal Code*, and even more importantly in regulators across the country seeking and obtaining an increasing range and severity of enforcement powers[2]. However it is arguably unclear that this will result in better outcomes for securities markets, if these are defined in terms of the achievement of fair and efficient markets that operate with integrity[3]. The strategy of attempting to improve market behaviour by imposing harsher sanctions in contested enforcement actions may fail. This

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[2] Examples include the recent acquisition by the OSC of the power to levy an administrative penalty, or order disgorgement of profits. See OSA s.127(1)#9&10
[3] See OSA s.1.1.

may come about for a number of reasons. One possibility is that this form of enforcement activity imposes such a high cost on regulators in terms of the resources it consumes that they may be unable to subject all significant breaches that come to their attention to rigorous sanctioning, thereby exposing themselves to a loss of legitimacy as a protector of investor interests. Another is that regulators lose legitimacy among the regulated community because their processes fail to provide the adequate amount of due process or because they are perceived to usurp the role of criminal courts.

A different order of possibility is that a regulatory enforcement style that focuses on deterrence may fail to achieve its desired outcomes because deterrence is an inadequate theory of the motivations of human behaviour. This is to say that there is some uncertainty that deterrence-type sanctions do in fact achieve the results of reorienting market participant behaviour[4]. In this respect, we would point to the comments of the Charles Rivers Associates study conducted for the Wise Persons Committee in 2003[5] to the effect that "it is very difficult to measure deterrence effects of enforcement activity". We also note the suggestion in the financial regulation literature that the salutary effect of publicity is greater at the time regulators launch an investigation than it is at the time the sanction is ultimately applied. Discussing the approach of the U.K.'s Financial Services Authority (FSA) to enforcement, Turner argues that

> "the imposition of public discipline would have the effect of improving the compliance culture within an organization… Unfortunately, publicity surrounding the issue often relates to events that happened some time ago and therefore the effect would be diminished….the more persuasive argument as to where the driver for an improvement in compliance culture emerged was FSA publicity at the time that it was announced that the FSA was intending to investigate a particular issue or event".[6]

It was also suggested in discussions at the Task Force- and CMI-sponsored roundtable on enforcement in February 2006 that deterrence effects might be quite idiosyncratic, in that negative publicity about a sanctioning decision made against a market actor does not necessarily result in a significant loss to that actor's reputation among investors.

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[4] See Dorothy Thornton, Neil A. Gunningham and Robert A. Kagan "General Deterrence and Corporate Environmental Behaviour" (2005) 27(2) Law and Policy 262; Tom R. Tyler "Promoting Employee Policy Adherence and Rule Following in Work Settings" (2005) 70 Brooklyn Law Review 1287

[5] For the details of their argument see Charles Rivers Associates "Securities Enforcement in Canada: The Effect of Multiple Regulators" in Doug Harris, ed. Wise Persons Committee Research Studies 458 at 477

[6] See Turner Vol 13(2) Journal of Financial Regulation and Compliance p. 142 at 144 and 145. Some of this problem might be mitigated by the strategic deployment of a settlement outcome, which would likely occur faster than a hearing-driven result, but settlements as an enforcement strategy also dilute the supposed salutary effects of harsh sanctioning.

This report seeks to contribute to the debate about how to achieve effective regulatory outcomes by suggesting that a reorientation of the regulatory approach to more proactive, ongoing, organizationally embedded monitoring might be a useful corrective. The underlying premise is that if compliance-type strategies can be expanded, or rendered more successful, this may reduce the need for back-end, reactive enforcement[7].

iv. What Kinds of Compliance-Based Strategies Are There?

In preparing this report, we have found useful a policy paper sponsored by the OECD on the topic of how to achieve regulatory compliance in a variety of contexts, and we use the insights from this report to frame some of our recommendations[8]. The OECD report's analysis begins with an account of three alternative explanations for non-compliance with regulation. These are: (i) the degree of market participants' knowledge of regulatory requirements; (ii) the degree of market participants' willingness to comply (whether because of economic incentives, good citizenship or other explanations); and (iii) the degree of their ability to comply. This suggests that comprehensive recommendations for improving market integrity outcomes need to address each of these potential causes of non-compliance.

In a somewhat different vein, we also note that organizations of all kinds have begun increasingly to operate by seeking to identify the sources of the most important risks they face (such as competitive risks, operational risks, legal risks and so on), and to prioritize planning around reducing or eliminating those risks. Such an approach encourages organizations to be reflective about the ways in which scarce resources can be used most effectively, and suggests a guideline for how both regulators and participants in securities markets should act. Adopting a risk-based approach, regulators would concentrate resources on eliminating behaviours that pose the most risk to the market,[9] and market participants would organize their internal activities to reduce or eliminate their sources of risk exposure, whether that be the risk of reputational damage, financial loss, regulatory sanction or liability. The compliance-based tools and strategies we enumerate briefly below, and discuss in more detail in the various case studies, can assist in operationalizing a risk assessment approach to regulatory or market activity.

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[7] Jonathan Edwards and Simon Wolfe "Compliance: A review" (2005) 13(1) Journal of Financial Regulation and Compliance p.48 at 56.

[8] Christine Parker "Reducing the Risk of Policy Failure: Challenges for Regulatory Compliance" Organisation for Economic Co-operation and Development, 2000 [hereinafter OECD report].

[9] A number of major securities regulators have adopted this approach, such as the FSA in the U.K. See Julia Black "Enrolling Actors in Regulatory Processes: The Example of UK Financial Services Regulation" at p.8.

Compliance strategies, of course, are varied. For example, one general approach underlying compliance-based strategizing is to change behaviour or decisions by changing the incentive structures within which those decisions will be made. The Ontario Securities Commission's (OSC) "credit for cooperation" policy is one enforcement-related example of this type of strategy. Another quite different approach would be to use technology to modify behaviour by controlling the actions that can be accomplished. A simple example of the latter is the way that the TSX's trading platform prevents a short-sale order being entered on a down tick[10].

Common compliance-based strategies include the following:

- the requirement to establish written policies to guide action, (such as compliance manuals) and to document actions taken, for example with respect to disclosing material changes;
- the establishment of sub-committees of a board of directors to oversee the organization's compliance with legal requirements (such as so-called compliance committees);
- the designation of compliance officers responsible for monitoring detailed compliance with regulatory requirements on a day-to-day basis;
- an emphasis on ongoing programmes of staff education about regulatory requirements and their implementation within the firm;
- external auditing of organizational processes: the most obvious example of auditing is in relation to financial statements but it can be used in a broader sense, such as for example, the idea of a "social audit";
- gatekeeper involvement: the deployment of third parties to assess the compliance of firms with regulatory requirements (for example, the role of underwriters and legal counsel in the prospectus process); and
- self-reporting policies: the adoption of regulatory policies or rules that provide incentives (often in the form of reducing or eliminating sanctions) to the regulated to self-report breaches of regulatory requirements.

v. Limits of Compliance

However there are limits to the role of a compliance orientation as a complete agenda for producing acceptable market behaviour. One shortcoming that might be perceived is that compliance-based

[10] Doing this would be an infringement of the Universal Market Integrity Rule (UMIR) that requires short selling only on an uptick. See Universal Market Integrity Rules (UMIRs) s.3.1(1)

strategies are by definition more low-visibility and routinized than high-profile prosecutorial-style action. Their expansion might therefore open regulators to the charge that they are “not doing enough” to regulate the market appropriately. A more intractable problem is the fact that it may be just as hard to measure the effects of compliance-type strategies on market behaviour, as it is to assert that deterrence-type strategies work to minimize rule-breaking behaviour. On the other hand, a feature of compliance strategies is that they tend to involve the collection of ongoing data about what organizations and the individuals within them are doing. They therefore allow for trends to emerge about rule-abiding behaviour. For example, the Corporate Finance branch of the OSC publishes the “outcomes” of its compliance activities in its annual report[11]. It is presumably possible to thereby assess trends in compliance from year to year, and perhaps even measure the effects on compliance that an enhanced rule requirement might have.

A further obvious problem is the potential costs that would be incurred by issuer and registrant organizations by the imposition of enhanced compliance-type requirements. Insofar as compliance strategies may impose more detail and formality on a variety of operational routines, or require the deployment of additional human resources, those costs will be borne by issuers or registrants across the capital markets in general, including those organizations which are generally law-abiding anyway. On the other hand, an approach to enforcing securities law that focuses more on reactive investigations and sanctioning processes will impose more specific costs on regulatory and public resources.

In addition, we acknowledge that an unintended consequence of a rigorous compliance programme might be that these requirements become a way for larger issuers to preserve a monopoly, in the sense that they are better able to meet the costs of compliance initiatives and so can drive out smaller operations[12].

These are challenging problems and pose some difficulty in light of the fact that it is beyond the scope of this work to attempt to quantify the costs of a variety of compliance strategies, and relate them to the costs of a sanctions-based approach[13]. We would note, though, that *ex post*, reactive sanctioning is a relatively blunt instrument for producing compliant behaviour among market participants, even if one assumes that market participants will be influenced to change their behaviour as a result of knowing that harsh sanctions are being imposed for some breaches of securities law. In a context in which it appears that

[11] For example, how many issuers committed to “disclosure enhancements in future filings”; how many were placed on the default list; how many restated their filings.
[12] See Andrei Shleifer “Understanding Regulation” (2005) 11(4) European Financial Management 439 at 446.
[13] Further information will be available about the costs of enforcement strategies in Canada as a result of Professor Howell Jackson’s research for the Task Force.

investors, especially retail investors, have a low tolerance for incidents of wrongdoing in capital markets, and are motivated to seek investments where good corporate governance and a commitment to social responsibility are a factor, it is worthwhile to consider the contribution that effective compliance-based regulation can make to producing market integrity. The foregoing does suggest, however, that more manageable compliance strategies will be those that require issuers to deviate as little as possible from a focus on their ongoing business activities.

4. Case Study #1: Abusive Sales Practices

i. Introduction

Financial intermediation is extremely important in the context of the Canadian capital markets. The IDA has over 200 investment dealer firms as members and close to 28,000 registered individuals who handle approximately $35 million in transaction value annually.[14] The MFDA regulates 177 firms and 68,434 registered salespeople with close to $279 billion of AUA.[15] Sales practices go to the heart of the enterprise of investing in the capital markets, and it is an area of intense interest among self-regulatory organizations, both the IDA and MFDA, as well as the provincial securities commissions.

The puzzle we analyze in this case study is the persistence of investor complaints around inappropriate investments and what investors perceive as mistreatment by sales personnel, despite many layers of compliance requirements and a very high level of firm-compliance tools and regulatory oversight. When considered in the context of the transaction value and assets under advisement, the absolute number of complaints of unsuitability (set out below) levelled against advisors is relatively small. However, the relationship between investor and advisor appears to be a significant source of frustration amongst retail investors, as noted at the OSC Town Hall meeting last year. As discussed in detail below, there may also be a mismatch of expectations between investors and their advisors. Nonetheless, the issue of unsuitable investments has a particular impact on retail investors and fundamentally affects their confidence levels and perception about the fairness and integrity of the financial intermediation system in Canada.

ii. Data on Complaints on Unsuitable Investments

Of the 1,841 events reported by IDA member firms via Comset[16] in 2005, 39% (or 732) dealt with the subject of unsuitable investments.[17] Table 1 shows that this percentage has been dropping since 2003 at which time it represented almost half of all events filed on COMSET.

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[14] IDA Enforcement Annual Report 2005 at 15.
[15] MFDA website. http://www.mfda.ca/members/memberstats.html. (Last accessed March 9, 2006).
[16] The IDA requires member firms to report all client complaints and disciplinary matters, including internal investigations, disciplinary actions, settlements, and civil, criminal or regulatory action against the firm or its registered employees, using ComSet, the database built to received and store such events filed by Members.
[17] IDA Enforcement Annual Report 2005 at 4.

Unsuitable investments were also one of the top four types of complaints received by the IDA complaints department in 2005 at 17%.[18] Table 2 show that complaints received by the IDA have also been dropping as a percentage, being at 23% in 2002.

Complaints of unsuitable investments were one of the top four issues referred to the investigation department at the IDA in 2005.[19] However, it is not one of the top 4 issues referred for prosecution.

Table 1: Complaints filed on COMSET by IDA Members

Year	Total Events Filed	Unsuitable Investments	Percentage
2003	2,670	1,248	47%
2004	1,896	785	41%
2005	1,841	732	39%

Table 2: Complaints received by the IDA

Year	Total Complaints Received	Unsuitable Investment Complaints	Percentage
2002	1,073	243	23%
2003	1,575	281	18%
2004	1,315	203	15%
2005	1,271	222	17%

iii. The Regulatory Framework

The know-your-client and suitability requirements are at the heart of the retail advisory relationship. IDA and MFDA rules require that when recommending to a customer the purchase, sale, exchange or holding of any security, the member must use due diligence to ensure that the recommendation is suitable for the customer, based on factors including the customer's financial situation, investment knowledge, investment objectives and risk tolerance.[20]

Layered on top of the suitability requirement is a rule that requires each member firm to designate a director, partner or officer, or in the case of a branch office, a branch manager, who is responsible for

[18] IDA Enforcement Annual Report 2005 at 5 and 7.
[19] IDA Enforcement Annual Report 2005 at 8.
[20] See for example, IDA Regulation 1300.(1).(q). Members can obtain an exemption from making a suitability determination if no recommendation is provided.

opening new accounts and supervising account activity.[21] He/she "shall ensure that the handling of client business is within the bounds of ethical conduct, consistent with just and equitable principles of trades and not detrimental to the interests of the securities industry".[22]

IDA Policy 2 and MFDA Policy 2 set out minimum requirements for retail account ongoing supervision at the branch office and head office level.[23] The compliance requirements are premised on the assumption that the stockbroker receives a commission for trades placed by a client.[24] The SRO policies require, among other things, that members establish their own written policies to document supervision requirements,[25] and maintain evidentiary documentation of supervisory reviews (inquiries made, replies received, actions taken, date of completion, etc) for seven years. The policies also require member firms to engage in ongoing reviews of sales compliance procedures and practices at head office and at branch offices[26] and engage in closer supervision of trading by approved persons who have had a history of questionable conduct at both the branch and head office levels.[27]

Branch office compliance requirements include daily and monthly reviews. The branch manager is required to undertake certain activities on a daily and monthly basis for the purpose of assessing compliance with regulatory requirements and the member firm's own policies. The branch manager is required to review the previous day's trades to attempt to detect lack of suitability; excessive trading activity; conflict of interest between registered representative and client trading activity; inappropriate high risk trading strategies; and quality downgrading of client holdings, among other things.[28] In addition to transactional activity, the branch manager is required to keep him/herself informed of other client matters including client complaints.[29] The branch manager is required to conduct monthly reviews of statements of clients, which produce gross commissions of $1,500 or more for the month.

Head office compliance also involves daily and monthly reviews. Under IDA rules, head office is required to conduct daily reviews of stock trades of transactions of significant value. For those shares with a price under $5 a share, the threshold is any transaction over $5,000. For shares over $5 a share,

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[21] IDA Regulation 1300.(2)
[22] IDA Regulation 1300.(2)
[23] See MFDA Bulletin at http://www.mfda.ca/regulation/notices/MR-0037.pdf . (Last accessed March 10, 2006).
[24] Member firms are required to develop supervisory policies for the review of non-commission based accounts (fee based accounts) at the branch and head office in lieu of the commission levels specified in the relevant rule.
[25] IDA Policy 2, Section 1.A.
[26] IDA Policy 2, Section I.B.2.
[27] IDA Policy 2, Section I.B.3.
[28] IDA Policy 2, Section III.A.1.
[29] IDA Policy 2, Section III.A.2.

head office must review transactions with a trade value of over $20,000. Recognizing that branch managers have a conflict in terms of reviewing their own trades, IDA rules require that head office review all client accounts of producing branch managers. IDA rules also require head office to review clients' statements which generated more than $3,000 commission during the month.[30]

SRO Policies also require their members to establish procedures to deal effectively with client complaints, including acknowledging all written complaints, and conveying the results of their internal investigation of a client complaint to the client. Members are also required to have to appropriate internal disciplinary procedures as well as procedures in place so that "senior management is made aware of complaints of serious misconduct and of all legal actions"[31] Firms are also required to report all client complaints and their resolution to the SRO via ComSet. Client complaints regarding unauthorized trading, fraud, forgery, or market manipulation must be reported even if the complaint is not in writing.

SROs also impose a requirement that each member firm have a Chief Compliance Officer (CCO). IDA Bylaw 38, for example, states that the CCO is responsible for designing and implementing a reasonable supervision and compliance system that can give the board of directors assurance that IDA rules and all other rules are being reasonably complied with. While the rule is mandated, much about the role and responsibility of the CCO and the appropriate system is left to the organization, as it probably should be. Nonetheless, securities regulators are currently devising a CCO examination so that there are some consistent proficiency standards across the industry.

The SROs engage in a number of proactive compliance-based strategies that reinforce the specific rules they have promulgated. The on-site periodic sales compliance examination or review by the IDA and MFDA is one such tool. For example, the MFDA just completed its first round of sales compliance review of all member firms over the last three years. The IDA uses a risk-based methodology which it states in its 2005 Annual Enforcement Report "has made the tailoring and prioritization of on-site examination programs much more precise, and therefore effective, processes".[32] The IDA categorizes members into nine distinct Peer Groups, which allows the SRO and the member to compare and contrast performance results between firms with similar profiles.[33]

[30] IDA Policy 2, Section IV.B.1.
[31] IDA Policy 2, Section VIII.3.
[32] Member Regulation Sales Compliance Annual Report 2005 IDA at 1.
[33] The Sales Compliance Risk Profiles by Peer Group are: Group 1- Integrated; Group 2- Retail, General; Group 2.2 – Retail Type 2 IB; Group 3 – Portfolio Managers; Group 4 – Discounters; Group 5 – Institutional Traders; Group 6; Corporate Finance; Group 7 – ATS; Group 8 – Other. See Member Regulation Sales Compliance Annual Report 2004 at 2.

In 2005, the IDA Annual Sales Compliance Report notes that frequent findings in sales compliance reviews continued to include failure to maintain up-to-date policies and procedures. It also noted that "patterns of sub-optimal supervisory practices" appeared to be on the rise. The explanation that is offered for this trend is that "the confluence of increasingly hectic markets, new and more complex investment products and rising regulatory requirements appeared to overtake the resources being fielded by Members in question". The 2005 IDA Report also noted that customer account documentation deficiencies continued to be a "frequent finding of reviews" including non-compliant forms. Another area of frequent deficiency findings was controls over advertising and sales literature, often on websites.

The 2003 IDA Annual Sales Compliance Report also notes that inadequate documentation of internal compliance activity and findings was a frequent finding. "Some Members, while they conduct adequate account reviews under Policy 2 and deal with problems uncovered, fail to adequately document what is done and found. The failure makes it difficult to determine whether the reviews are in fact being done as required by Policy 2 and leaves the Member under-protected in the event of a client complaint or lawsuit".[34]

Most findings from SRO on-site examinations are handled by the SRO compliance department informally, but pervasive or egregious breaches that are uncovered are referred to the SRO enforcement departments for informal administrative action or formal processes.

iv. Analysis

Despite what appears to be a multi-pronged compliance framework, as discussed above, there remains a persistence of complaints centred around unsuitable investments. A number of observations and recommendations are set out below for the Task Force's consideration.

a) Relationship between Complaint Levels and Market Conditions

There appears to be an inverse relationship between the frequency of complaints by investors of unsuitable investments and general market conditions. As noted in Tables 1 and 2 above, the total level of complaints received as well as specific complaints on suitability have been decreasing since 2003. There is anecdotal evidence that suggests the number of complaints and, in particular, complaints about

[34] Member Regulation Sales Compliance Annual Report 2003 IDA at 3.

suitability are directly related to how buoyant the markets are. That is to say, there appears to be a marked increase in the number of complaints and suitability complaints in step, albeit somewhat delayed, as between a bull market and a bear market. It is reasonable to assume that people take a more critical look at their account statements if there are losses in their investments or there has been a reduction in returns. Given the markets have been providing reasonably good returns in each of the past successive years, this may be a partial explanation to the downward trend of complaints generally and of unsuitable investments in particular. The general reaction on unsuitability appears to be decrease as market conditions improve. More claims of unsuitability are generated when investors lose a percentage of their portfolio in the markets.[35]

This analysis suggests that greater efforts should be made by commissions and SROs to educate investors about market risks and losses and the appropriate bearing of responsibility when an investment has negative returns. We recommend that investor education resources be focused on this topic. Consideration should also be given to requiring financial advisors to specifically disclose the risk associated with entering into a particular transaction before the transaction is entered into, and its effect on the client's overall portfolio in terms of risk, return and diversification. There is currently no standard terminology used in the industry to describe risk. Firms and individual advisors are free to use a broad variety of terms that may mean different things to different people. There should be some standardization of risk so that it can be clearly articulated and understood. It should also be noted that assessing risk only at the time of the transaction can be potentially dangerous. Investments are dynamic and the risks associated with them vary over time. As such, consideration should also be given to a continuing obligation to disclose the relevant risks post-purchase on a client's periodic statements.

<u>**Recommendation #1:**</u> **Securities Commissions and SROs should make greater efforts to educate investors about market risks and who should bear the risk of loss when investment losses are incurred in the marketplace. Greater education should also be provided on the importance of a diversified portfolio.**

[35] Generally, complaints are linked to monetary loss suffered by a client, but that is not necessarily exclusively so. In rare circumstances, clients do complain that they have been put into unsuitable investments on the basis that they did not make enough money or they would have made more money had they been put in proper investments.

<u>Recommendation #2:</u> Financial advisors and their firms should be required to disclose the risk associated with any particular investment at the time that the transaction is entered into, in a manner that is easily understood, and the effect of the transaction on the client's overall portfolio in terms of risk, return and diversification.

b) Disclosure of Compensation

We strive for investment advice to be provided and investment decisions to be made on the basis of the client's best interests and the client's risk tolerance and expected return. In a well-functioning market, we also expect strong price competition for financial intermediation services that are rendered.

There appears to be a fair amount of disclosure of fees in the context of secondary market trading of shares, as noted the Fair Dealing Model Concept Paper.[36] For example, discount brokers generally highlight their trading fees upfront. Full-service brokers generally provide commission amounts on transaction confirmation slips post-trades. However, there are many problems with the current system in respect of compensation. A few examples are set out below:

- In the context of IPOs, investment banks generally offer their financial advisors higher compensation than secondary trades to sell the IPO, which is not problematic per se, but can skew a financial advisor's advice to a client.[37]
- While commissions are generally not charged on trading in bonds, some investors may not be aware that the firm and advisor are being compensated through the buy-sell spread.[38]
- The complexity and lack of transparency of mutual fund fees (including multiple sources and multiple time periods) make it difficult for an investor to have a good appreciation of the actual costs associated with their investment. The fact that the financial advisor and his/her firm may receive large fees from a third party source may also create a conflict of interest that is detrimental to the client.[39] The fact that the fees are disclosed but often buried in a lengthy prospectus makes such disclosure meaningless in many cases.

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[36] The Fair Dealing Model, Concept Paper of the Ontario Securities Commission (January 2004). See also Glorianne Stromberg, Investment Funds and Consumer Protection Strategies for the Millennium (1998) and Glorianne Stromberg, Regulatory Strategies for the Mid-90s: Recommendations for Regulating Investment Funds in Canada.
[37] Fair Dealing Model, at 63.
[38] Ibid.
[39] Ibid.

It must be acknowledged that deep-rooted individual and organizational compensation incentives can have an impact on an individual advisor's recommendations to a client to buy, sell or hold certain securities.[40] The advisor's interests can be skewed in favour of those products that will offer him/her a larger commission or compensation package. These concerns are exacerbated particularly in a context when there are multiple sources of fees and the fees are not disclosed in an easily accessible way to the investor before the investment is made.

How should securities laws address the issue of conflicts of interest in the context of compensation biases? In certain contexts, regulators view the conflict to be so grave that they create a bright line rule prohibiting the activity. For example, IDA Rule 11 clearly sets out that research analyst compensation cannot be tied to the profitability of the investment bank. Certain forms of compensation are also prohibited in the mutual fund context.

Commission-based compensation structures are certainly the cause of some of the concerns noted above, but that is not to say that other compensation models, such as flat-fee accounts, are the panacea, as they create different but equal problems in respect of differing interests between the advisor and the client.[41] It is unlikely that Canadian regulators will be prepared to prohibit all commission-based sales practices across the board, and we do not go so far as to recommend prohibition in this study. In the context of compensation of financial advisors, we do, however, recommend greater transparency and more accessible disclosure of the fees to investors at critical stages in the advisor-client relationship. The recommendations discussed below should allow investors to make informed decisions and also may encourage greater competition in the industry.

At the time of account opening, firms and financial advisors should be required to disclose in a brief document a list of compensation options for the services that will be provided (whether or not they are available at that firm), and the particular compensation options available at that firm and by that advisor. We encourage intermediaries to make available to clients multiple options for compensation, including non-commission based options.

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[40] See, for example, Donald Langevoort, Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics about Stockbrokers and Sophisticated Customers, 84 Cal. L. Rev. 627 (1996).
The data shows that commissions on trades account for 59% of revenues of full-service brokers in Canada, while flat fees on accounts account for 29%. However, fee-based accounts are on the rise. Spreads accounted for 10% of revenues and "other" accounted for 2%. See Earl Bederman, Investor Economics, 'Canada's Wealth Management: Opportunities and Challenges for Retail Brokerage" (June 15, 2004) at 15.

At the time of any particular transaction, the financial advisor should be required to disclose, in a brief transaction summary document, the total dollar value of the compensation the investor has paid or is obligated to pay, directly or indirectly, to the advisor and his/her firm. Any compensation and benefits that will be received by the financial advisor and the firm from third parties should also be required to be disclosed. Finally, financial advisors should also be required to disclosure the dollar value of the compensation that would have been paid by the client had he/she selected another compensation option for the relationship at the time of account opening, or another compensation method for the particular transaction. It must be stressed that the document should contain sufficient information that is provided in a succinct, clear document that relies on plain language that is understandable to the average, educated, reasonable investor. However, if it is more than one or two pages, it is unlikely that most people will read it.

At year-end, financial advisors should be required to disclose the total fees paid by the client over the year, as well as fees that would have been paid under other options, so that the client can choose to change the compensation model on a going-forward basis.

<u>Recommendation #3:</u> At the time of account opening, firms and financial advisors should be required to disclose the following information in a brief (one- or two-page) document: (a) a list of compensation options for the services that will be provided (whether or not available at that firm); and (b) the particular compensation options available at the particular firm and by that advisor.

<u>Recommendation #4:</u> At the time of a particular transaction, the financial advisor should be required to disclose, in a brief (one- or two-page) transaction summary document, the total dollar value of compensation the investor has paid or is obligated to pay, directly or indirectly, to the advisor and his/her firm. Also to be disclosed would be any compensation and benefits that will be received by the financial advisor and the firm from third parties. Financial advisors should also be required to disclosure the dollar value of the compensation that would have been paid by the client had he/she selected another compensation option for the relationship at the time of account opening, or another compensation method for the particular transaction.

<u>Recommendation #5:</u> At year end, financial advisors should be required to disclose the total fees paid by the client over the year as well as fees that would have been paid under other options.

c) Financial Advisors’ Proficiency and Publicity of Proven Complaints of Abusive Sales Practices

Consideration should also be given to replacing the current salesperson mentality, which is often underscored by the commission system of compensation noted above, with one that encourages increased professionalism and independent advice. Currently, certain classes of salespeople can sell securities with very little formal education and after completing courses which can take only a few months. There is also no formal period of apprenticeship, which can offer benefits of mentorship and role modelling of good behaviour and practices. Firms should be encouraged to take the initiative to impose higher standards of proficiency on their employees, as a part of their business model to distinguish themselves from their competitors. This approach could be encouraged by regulators requiring that advisors disclose in their account-opening document the financial advisor’s education and qualifications. This should also be supplemented with information about the advisor’s experience in the industry as that also has an impact on the quality of advice that is offered to clients.

Regulators could also consider mandating disclosure of proven complaints of unsuitability or other abusive sales practices to new clients at the time of account opening and also to existing clients by requiring publication in hard copy and/or on the advisor’s website. It should be noted that the IDA maintains on its website, with free access by the public, a history of any registrant and firm from 1997 onwards, including a complete record of hearings and particulars, the findings, the reasons and the penalty. However, this places the onus on a client to seek out such information. The possibility of negative publicity by requiring specific disclosure of proven complaints to clients may act as a stronger disincentive against acting inappropriately in the first place. To ensure that the advisor does not minimize the effect of this recommendation by presenting and explaining away the relevant complaints in a certain way to clients, it would be useful to standardize what information must be conveyed to the client and the format in which it must be presented.

In conjunction with the recommendations above, regulators could also consider a more direct approach and impose heightened proficiency requirements and professionalism standards that currently required, to imbue a greater sense of professionalism in the industry. It should be noted that heightened *regulatory* standards for individual proficiency would be in sharp contrast to the one-time proposed B.C. model of registration, which would have focused only on firm-level registration and left the competencies of individuals to the firms to address on their own. Higher regulatory standards of proficiency may also be difficult to justify on the basis that the increased cost of compliance with the heightened requirements will be borne by all individuals whereas the data shows that the complaints of unsuitability are rather localized, as noted in the next section.

<u>Recommendation #6:</u> Firms should be encouraged to impose higher standards of proficiency on their employees than those currently required by regulators, as a part of their business model to distinguish themselves from their competitors.

<u>Recommendation #7:</u> Regulators should also consider imposing heightened proficiency requirements and professionalism standards that currently required, to imbue a greater sense of professionalism in the industry.

<u>Recommendation #8:</u> Regulators should mandate disclosure of the advisor's educational background, qualifications and experience at the time of account opening, including any qualifications that are above and beyond minimum regulatory requirements.

<u>Recommendation #9:</u> Regulators should require advisors to disclose to new and existing clients any proven complaints of unsuitability and other abusive sales practices.

<u>Recommendation #10:</u> Regulators should require advisors to disclose proven claims of unsuitable investments and other abusive sales practices to new and existing clients.

d) Localized Complaints and the Limits of Compliance Strategies

Investor dissatisfaction with respect to sales practices appears not to be widespread across the financial services industry. Rather, it is more isolated. Of the total 25,000 registrants supervised by the IDA, 22,805 had no complaints against them during the period October 2002 to December 2005.[42] 2,210 registrants were the subject of one complaint during this period, 587 were the subject of two complaints, and 27 were the subject of 10 or more complaints. This suggests that bad practices with respect to investor contact are somewhat localized.

Do these localized problems tend to come up with respect to sales personnel in smaller, more transitory firms, or are they spread across the gamut of registrant firms? It is difficult to say. In general, the larger firms have greater controls, particularly bank-owned firms. In part, this is because they have greater

[42] Paul Bourque, PowerPoint Presentation, 2005 SRO Compliance Conference (January 26, 2006).

resources available to them to conduct compliance whereas smaller firms are constrained by their relative size. It is likely that those firms that are in the bottom tier attract advisors who have less stellar performance or an adverse history in terms of regulatory breaches.

While the IDA assesses each complaint on an individual basis, the worse the advisor's track record in terms of past complaints, previous warnings and previous discipline, the less likely that a compliance strategy will be effective. In certain cases and at certain times, advisors need to be weeded out of the industry as opposed to using a compliance approach, which clearly has its limits. At some point, we should not, as a policy matter, expend resources in trying to "rehabilitate" egregious and persistent offenders. A more appropriate policy may then be to deny them their licence to provide financial intermediation services.

<u>**Recommendation #11:**</u> **The compliance approach should not be used for persistent and egregious offenders who continuously engage in abusive sales practices. Instead such offenders should be removed from the industry.**

e) Sensibility of the Risk-Based Approach to On-Site Sales Compliance Examinations

Risk-based reviews by regulators in relation to on-site sales compliance examinations appear sensible, as the costs of such reviews are then borne by those market participants who pose the greatest risk of harm based on their previous conduct or their line of business; lesser-risk market participants can thereby avoid the potentially onerous cost of frequent reviews. Nonetheless, we believe that risk-based reviews should be balanced with the threat of possible random reviews on the entire regulated population. As well, we must be confident in the risk factors and methodology used by regulators to select the firms, and regulators need to periodically review such factors. While much attention is paid to improving the mechanisms used to address and resolve actual investor complaints of unsuitable sales practices, we also encourage regulators to respond to investor concerns by obtaining their input into how the risk-based methodology is defined and what factors are considered relevant. It is noteworthy that the IDA does take into account the frequency of suitability complaints at particular firms and/or branches in determining which firms and branches are the targets of sales compliance audits. The OSC's newly created Investor Advisory Committee could be one such vehicle to provide this sort of retail investor input on matters of suitability and other abusive sales practices.[43]

We would also encourage firms to use a risk-based approach internally within their organizations to ensure that salespeople and branch offices are meeting the baselines expected of them, and also to identify and deal with particular salespeople and branch offices that are particularly troublesome in terms of the issue of abusive sales practices.

<u>Recommendation #12:</u> Regulators should be encouraged to obtain retail investor input how the risk-based methodology for sales compliance audits is defined and what factors are considered relevant in determining which firms become the subject of such audits.

<u>Recommendation #13:</u> Firms should be encouraged to use a risk-based approach internally within their organizations to ensure that salespeople and branch offices are meeting the baselines expected of them, and also to identify and deal with particular salespeople and/or branch offices that are particularly troublesome in terms of the issue of abusive sales practices.

f) Prosecution of Unsuitable Investment Matters

As noted above, "unsuitable investments" is the most frequent complaint category filed under COMSET. It is also one of the top four types of complaints at the IDA complaints and at the IDA investigations department, but it is not one of the top four issues dealt with by the IDA prosecutions department.

There are many reasons for this, which may explain why there is not a linear relationship between complaints and resulting prosecutions.

First, prosecutions are based upon available evidence and the probability of success in going forward. Suitability matters can relate to a full spectrum of issues. Some suitability cases are stark and there may be significant credible evidence, which can be led that will clearly demonstrate that the registrant failed in

[43] The Investor Advisory Committee was created by the OSC in November 2005. It is comprised of 11 volunteer members from Ontario who have knowledge of securities issues as they impact retail investors, as well as experience representing the needs of investors on a broad scale. The committee is chaired by Professor Eric Kirzner of the Rotman School of Business. Other members are: William Gleberzon (CARP), Robert Goldin (MacGold Direct), John Hollander (Doucet McBride LLP), Gloria Hutton (Private Investor), Richard Manicom (Private Investor), Poonam Puri (Osgoode Hall Law School), Pamela Reeve (Private Investor), Kelly Rodgers (Rodgers Investment Consulting, Ellen Roseman (Toronto Star) and Whiplle Steinkrauss (Consumer Council of Canada). A detailed analysis of this newly created body is contained in Julia Black's paper for the Task Force entitled Retail Investor Input into Securities Regulation.

its obligations. In other cases, suitability can be measured in shades of grey. In other words, there may not be the necessary clear and cogent evidence that would result in a hearing likely to be successful. The result is that the matters may be resolved through informal resolution or closed with no action. In other circumstances complaints about suitability are not in fact about suitability at all but merely reflective of general market conditions, as discussed above.

Similarly, and as with most prosecutions, enforcement counsel may review a number of allegations that have been investigated and use discretion as to which complaints to proceed with and which files to close. As an example, in an extreme case, the SRO may receive multiple complaints about suitability of investments by a single representative. It would likely be deemed unnecessary to proceed with all of the allegations; and it may be that one or a few of them will proceed, if there is sufficient evidence to do so. The result would be the same in terms of furthering the goals underlying public prosecutions.

In some cases, decisions about prosecuting are effectively made for the regulator. This occurs when clients withdraw their complaints or refuse to attend as witnesses. Case law suggests that in the absence of a client witness it is very difficult to prove a case of suitability.[44] Where witnesses are compensated, the monetary incentive for them to provide assistance in a regulatory hearing disappears, and in many of those circumstances the regulator is unable to proceed with the prosecution. The IDA does not have any ability to compel third parties as witnesses in its hearings, and there have been some very significant cases that have been frustrated by the refusal of complainants to testify. It is one of the drivers behind the IDA's continuing requests for some statutory powers to compel witnesses and third-party documents for their investigations and hearings.

Another issue to consider is that the suitability of a product may vary with time. Nortel is one such example. At one point in time, Nortel shares would have been considered low-risk and suitable as a blue chip stock. With their continuing accounting issues and corporate governance practices, most reasonable people would agree that Nortel is now more likely to be considered high-risk and indeed speculative, not suitable for low-risk clients. In those types of situations, registrants and clients need to weigh how best to resolve investments that have changed their profile over time. Indeed, many of the suitability complaints referred that the IDA has received were in relation to Nortel. In the worst case scenario, immediately selling a security that has suddenly lost its lustre and low-risk status may not be an option, or not necessarily one that is in the interest of the clients. In the worst case scenario, there may be no market, as was the case in something such as YBM Magnex and Bre-X. The fraudulent behaviour in those types of

[44] See IDA v. Shanks.

cases was not only visited on investors, but the public as a whole. Therefore, it is a suitability concern, but not one that was foreseeable or through the actions of the advisor.

The final point is that quite often matters are initially reported or investigated as suitability matters but turn out otherwise. During the course of investigation, evidence may be uncovered that would suggest the matter is not a suitability matter but instead a different type of misconduct, or that there are more serious allegations that subsume the suitability complaints. In such cases many suitability matters may in fact be contained in the more serious allegations or it might be converted to other types of regulatory breaches such as conduct unbecoming. Examples of this type of situation are some of the RSP asset-stripping schemes that were initially reported as suitability but, when investigated, were situations where the registrant has received secret commissions and participated in a criminal scheme that places it in the realm of conduct unbecoming.

All of the examples go a long way to explaining why suitability does not result in a linear type of result in prosecutions from complaints, case assessment and investigations. The point of this discussion is that back-end prosecutions by the SROs are limited as a source of evidence about the success of compliance-based strategies in the context of abusive sales practices.

Recommendation #14: The IDA should be provided with statutory authority to compel third-party witnesses to appear before it in regulatory proceedings, so as to enhance the effectiveness of its enforcement proceedings.

5. Case Study #2: Insider Trading

i. Recent Regulatory History of the Insider Trading (IT) Problem

For a number of years now, insider trading has been considered to be a significant securities regulatory problem in Canada, with action being taken on a number of fronts. Much media attention was paid to a study undertaken in 2003 by Professor Bris of the Yale School of Management that purported to provide empirical information to the effect that the stock markets of many countries, including Canada, exhibited high rates of insider trading[45]. More recently, Tom Atkinson, the CEO of RS, has asserted that the "Canadian securities industry ranks insider trading as one of the top risks to market integrity in terms of likelihood, trend and impact". At the regulatory level, the CSA formed an Insider Trading Task Force (ITTF) in September 2002 that made a large number of recommendations for action on this front[46]. In September 2004, the Criminal Code was amended to introduce a specific offence of insider trading, in addition to the quasi-criminal prohibitions already existing in most provincial securities legislation[47]. This legislative expansion coincided with the further development of the IMETS enforcement strategy[48].

Meanwhile, insider trading has also become a significant target of enforcement action by provincial securities commissions. Data from a study of the exercise of public interest enforcement powers for 2000-2003 period, conducted in 2003 by one of the co-authors, shows some priority accorded to the problem of failure to file insider trading reports in a number of provinces, such as British Columbia, Quebec, and to a lesser extent, Ontario[49]. Since that time, the attention paid to insider trading by the OSC in particular has continued to increase, as evidenced by its use of both its OSA s.127[50] and quasi-criminal powers[51] to address the problem. Thus, insider trading represents something of a high-water mark for a deterrence-based approach to regulatory efforts to control an undesirable market practice. Finally, RS has also

[45] The published version of this report is Arturo Bris "Do Insider Trading Laws Work?" (2005) 11(3) *European Financial Management* 267-312.

[46] Insider Trading Task Force "Illegal Insider Trading in Canada: Recommendations on Prevention, Detection and Deterrence", November 2003. In all, the ITTF made 32 recommendations. While a few of these are not being acted upon by regulators, the majority of the recommendations either have already been implemented or are being further considered by them. Reference will be made below to a number of these initiatives.

[47] While the ITTF recommended that the federal government reconsider the approach taken in the language of this new offence, so as to avoid prosecutorial difficulties of proving a "knowing use" requirement, it did support the introduction of the current version

[48] Poonam Puri "Enforcement Effectiveness in Canadian Capital Markets" Capital Markets Institute, December 2005.

[49] Mary Condon "The Use of Public Interest Enforcement Orders by Securities Regulators in Canada" Wise Persons Committee Research Studies (Douglas Harris, ed) December 2003.

[50] Donnini (2002) OSCB 6225; ATI Technologies; Popovic settlement (May 2005); Harper (2004) 27 OSCB 3937; Gillam settlement (March 2006).

[51] R v Harper [2000] OJ No. 2791 (CJ); [2003] OJ No. 4196 (CA); R v Rankin [2005] OJ No 3202

devoted considerable resources to the enterprise of real-time market surveillance of trading so as to increase regulatory capacity to identify incidents of insider trading[52].

ii. Current Compliance-Based Approaches to Insider Trading

It cannot be denied that the regulatory response to the problem of insider trading has important proactive or compliance-based components. Such strategies include:

- Insider reporting rules under provincial securities acts such as OSA s.107. These are generally considered to have the dual function of (i) alerting investors about trading by insiders (assumed to be valuable information in itself) and (ii) deterring insider trading on the basis of material undisclosed information.[53] Canadian insider reporting rules are considered by some large issuers to be more onerous than their counterpart rules in the U.S., with respect to the number and type of insider captured by them, and the need for assessments by corporate secretaries as to whether insiders are exempting themselves appropriately from the scope of the rules.
- The exhortation to issuers in CSA NP 51-201 to adopt a series of disclosure best practices, including the development of an insider trading policy "that provides for a senior officer to approve and monitor the trading activity of all your insiders, officers, and senior employees". This policy should prohibit trading while in possession of material non-public information. The policy further recommends observing "blackout periods" when trading may typically not take place, especially surrounding "regularly scheduled earnings announcements[54]". A compliance review undertaken by the OSC's corporate disclosure team in 2002 canvassed the proportion of reviewed issuers that had "blackout policies", and discovered that a high percentage did[55]. This review does not appear to have been repeated more recently.
- Some recent OSC settlements have included the requirement that the respondent implement an insider trading and reporting policy[56]. The OSC has also granted exemptive relief from the insider reporting requirements on the basis that the reporting issuer (RI) has a "blackout period" policy[57].

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[52] See ITTF report at p.4 which notes in full that "although many suspected incidences of illegal insider trading are being identified through market surveillance, there have been few successful enforcement actions".

[53] See Condon, Anand and Sarra, *Securities Law in Canada: Cases and Commentary* (Emond Montgomery Publications, 2005).

[54] NP 51-201, s. 6.11, 25 OSCB 4492.F

[55] Specifically 72% of 517 reviews (which figure represents 29% of active Ontario-based issuers) uncovered such policies.

[56] See settlements such as Popovic (May 2005); Paradigm Capital (June 2004).

[57] See CP Ships (October 2003); Shoppers Drug Mart (June 2002).

- OSC Policy 33-601[58] directed to registrants with respect to containment of inside information. This policy advocates that registrants "consider establishing written policies and procedures in the following areas: (a) education of employees; (b) containment of inside information; (c) restriction of transactions; and (d) compliance[59]". With respect to the latter, it is suggested that registrants should: (i) monitor and review trading for the registrant's account; (ii) monitor and/or restrict trading in securities of issuers about which the registrant or its employees possess or may possess inside information; (iii) monitor, review and/or restrict trading of all employees and in particular, those who might be in the normal course in receipt of inside information; (iv) require a senior officer to be responsible for the implementation and enforcement of the policies and procedures; and (v) institute a periodic review of the adequacy or these procedures, "including a written report on their effectiveness to senior officers or the board of directors[60]". CSA staff undertook a National Compliance Review of advising issuers in 2001. This reported that ten out of the fourteen issuers reviewed had deficient procedures relating to personal trading practices such as insider trading or front running. In these issuers blackout periods were found to be non-existent or inadequate[61]. It should be noted that, as part of the regulatory response to the recommendations of the ITTF, OSC Policy 33-601 is currently under active consideration by Canadian securities regulators for reformulation into a National Instrument.
- Role of SROs in compliance. The IDA reviews member practices with respect to so-called grey and restricted lists and information barriers as part of its sales compliance process. As part of its trade-desk compliance function, RS reviews trading by dealers to attempt to ensure that no insider trading is occurring. It also operates a market surveillance function to identify unusual trading patterns that may signal trading on the basis of undisclosed material information[62].

iii. What Do We Know About the Scope of the IT Problem?

The ITTF notes the "public perception that illegal insider trading is prevalent and increasing on Canadian markets[63]", though it also admits that "it is currently very difficult to establish accurately the extent of insider trading, much less illegal insider trading, that occurs on Canadian markets[64]". Bris' research

[58] Guidelines for Policies and Procedures Concerning Inside Information 21 OSCB 617.
[59] Supra at s.2.1.
[60] Supra at 2.7.
[61] OSC Staff Notice 33-720 25 OSCB 5063.
[62] ITTF at p.17.
[63] ITTF at p.4.
[64] Ibid at 7.

suggests that insider trading is often linked to merger announcements[65]. However, other enforcement matters pursued by regulators link insider trading to disclosure of periodic or timely information by issuers, or alternatively, delays in reporting negative information[66]. The ITTF also noted that insider trading may occur in the context of "bought deals", especially from parties solicited about participation in the deal who do not ultimately take part.[67]

There is a further dearth of systemic information available about how compliance-type policies like the containment of information or the application of "blackout" periods are actually working in the context of issuers or registrant firms. Anecdotally, however, cases like *Rankin* suggest that there are shortcomings[68].

iv. Is the Current Mix of Strategies Appropriate?

Despite the relative lack of hard information about how widespread the problem of insider trading is in Canada, as we have suggested above, there is a view among regulators and investors that the presence of insider trading damages the reputation of the market in general, harms investors, and may increase the cost of raising capital. The introduction of the new Criminal Code offence and the increase in enforcement sanctioning action appear to represent a heightened commitment to deterrence of insider trading. The recommendations of the ITTF report itself pursued the same strategy[69]. Indeed, one of the commentators at the enforcement roundtable sponsored by the Task Force and CMI in February 2006 saw the core of the problem in Canada as being that not enough insider traders do the "perp walk", as witnessed in the U.S[70]. The question raised by this research study is whether that approach is an adequate response, or whether there is an expanded role that may be played by compliance-type strategies in controlling the problem.

We argue that a focus on prosecution and deterrence may be an inadequate response for a variety of reasons. It is a systemic problem of prosecutorial strategies that they take significant time to achieve a

[65] The *Rankin* matter is one anecdotal data point here.
[66] See cases like *Pezim; Harper; ATI*
[67] The ITTF therefore suggests that better records should be maintained by dealers concerning those solicited in connection with a bought deal, as a way of assisting in any future investigations of connected insider trading. Supra at p. 17.
[68] See Mr. J. Khawly's comments about the passing of information around the M&A department in RBC
[69] This is signaled in the very subtitle of the report which is "Recommendations on Prevention, Detection and Deterrence".
[70] Regulators may also be cognizant of the strongly- stated conclusion of Bris' paper on IT laws to the effect that "The only way of reducing the potential benefits of breaking the law is to improve a firm's disclosure requirements, increase penalties, and improve the detection technology[70]". Even more bluntly, Bris argues that "it is worse to have a regulation that fails to prosecute those who violate it… than no law at all (*supra* at 309-310)".

result, so that the effect of a prosecutorial sanction of market actors may be diluted by the passage of time. Not all market participants will know that a result has been achieved or be aware of the details. There is also some suggestion that the effects of punitive sanctions on general market behaviour are transient, and may not ground long-term changes in behaviour. Punitive sanctions may also be less effective where organizational incentives operate at odds with legal or normative requirements.

Thus, the insider trading issue presents in stark relief the ongoing dilemma of whether regulatory enforcement efforts should be properly directed at an organization or those individuals employed by them[71]. In a variety of economic and social regulatory arenas, emphasis has been increasingly placed on whether organizations have appropriate monitoring systems in place, as opposed to a focus on punishing the lone "bad actor[72]". This is in part a response to the recognition that regulators (including securities markets regulators) cannot deal themselves with every regulatory problem singlehandedly, and therefore need to enrol organizations in the regulatory task as well. On the other hand, it may be argued that insider trading is precisely one of those behaviours that is engaged in by lone individuals, motivated primarily by personal gain rather than any misguided attempt to benefit the organization in which they are employed.

The recent *Rankin* decision in Ontario exemplifies the tension here, in that the decision included adverse comment on the procedures of the M&A department of the investment bank as well as about the character of the principal actors[73] involved in the illegal activity. Ultimately, we would argue that individuals are embedded in organizations. Those organizations might be legitimately expected to communicate expectations, and monitor conformity with those expectations, as part of the responsibilities they undertake in return for access to the capital markets. While organizations cannot be expected to completely control the activities of their employees who are determined to evade legal requirements by subterfuge, there are steps that can and should be taken to limit the possibilities for illegal trading activity to take place and thereby reduce risk to the organization itself.

If our argument is persuasive, it suggests that there are at least two dimensions to the problem of insider trading: (A) assuming that greater focus should be directed at organizations, whether those organizations

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[71] It should of course be noted that there are a variety of types of organization relevant here: issuers, registrants, law firms and accounting firms. The ITTF made a number of recommendations directed specifically at information containment practices within law firms, accounting firms and banks, which are being pursued by the relevant self-regulatory and regulatory bodies. Other recommendations that marketplace timely disclosure policies be revised to recommend to issuers that they use only lawyers and accountants whose firms have adopted best practices for information containment is not under current consideration for action

[72] See Jonathan Edwards and Simon Wolfe "Compliance: A review" (2005) Vol 13:1 Journal of Financial Regulation and Compliance 48 at 50.

[73] That is, Andrew Rankin and Daniel Duic.

should be subjected to greater regulatory pressure to have internal policies directed to the prohibition and surveillance of insider trading, and (B) whether there are policy recommendations that could be made about how to promote compliance with these policies by individuals within firms.

a) Broadening Requirements on Issuers to Maintain Insider Trading and Reporting Policies

The ITTF recommendations on prevention included the dissemination of an information package to officers and directors of issuers on receipt of their filing of a Form 4B with an exchange or provincial securities commission. This information package was to include "responsibilities and guidelines applicable to information containment, timely disclosure and insider trading restrictions, as well as background on the underlying market integrity standards and potential sanctions[74]". However, the issue to be addressed in this section is whether the regulatory rules should go further, so as to mandate an issuer's development of insider trading policies, especially the reliance on "blackout periods".

One possibility for accomplishing this would be to require the existence of such a policy to be disclosed as an item in a reporting issuer's AIF, or a prospectus pursuant to an IPO. AIFs are set to assume even greater significance with the broadening of the short-form prospectus (SFP) process to encompass most issuers. Venture issuers do not need to file AIFs under NI 51-102, but would be required to do so if they wished to access the SFP option. Under our proposal, junior issuers would also be required to have an insider reporting and trading policy if they used a long-form prospectus to accomplish a financing. This proposal would assist with the transparency of information about insider trading policies that is necessary to create a "culture of compliance" in this area. It would signal to issuers the significance in which regulators held the problem, and it would be an efficient mechanism for supporting regulatory monitoring of the existence of such policies, since review of the existence and content of an insider trading policy would be part of a more holistic prospectus/AIF review process. Another effect of introducing this requirement would be to allow the issuer an opportunity to signal its commitment to reducing IT at an organizational level. Finally, we note that an RI insider trading policy is a mandatory requirement under U.S. securities law.

Meanwhile, NI 58-101[75], dealing with disclosure of corporate governance practices, and promulgated by the CSA in June 2005, contains the requirement that reporting issuers disclose, either in a management information circular or an AIF, "whether or not the board has adopted a written code [of ethical business

[74] ITTF supra at p.11.This recommendation is currently being pursued jointly by the OSC and the TSX
[75] NI 58-101 –Disclosure of Corporate Governance Practices 28 O.S.C.B 5377

conduct] for the directors, officers and employees". The policy accompanying NI 58-101 indicates that the code of business conduct and ethics should address a number of issues, including "confidentiality of corporate information", as well as "compliance with laws, rules and regulations" and "reporting of any illegal or unethical behaviour". To the extent that the introduction of this instrument will have the effect of fostering a greater attention among reporting issuers to the issue of insider trading specifically, it is of course a welcome development. We would propose however that insider trading is a sufficiently significant concern that it would be preferable to impose a requirement for reporting issuers to explicitly address this matter in their filings, whether this be accomplished by an amendment to NI 58-101 or to NI 51-102, dealing with the general content of an AIF.

Recommendation #15: Regulators should mandate that all reporting issuers develop and file an explicit code of conduct dealing with prohibitions on insider trading and insider reporting policies.

Should the content of an issuer's insider trading policy be mandated by regulators? In any event, what might the elements of such a policy be? In general, it is likely that the issuer can evaluate best where it is most vulnerable to compliance failures with respect to its IT policy. Thus, for a mining company it might be around the system for internal dissemination of drilling results, whereas for a registrant it might have to do with procedures for allocating staff to work on specific transactions. As the ITTF report indicates, some guidance is available from the IDA's initiative to draft a set of best practices for information containment based on OSC 33-601, as well as from a set of best practices drafted by a group of Vancouver investment dealers with respect to private placements specifically[76]. While it is likely that most RI policies dealing with insider trading would adopt a "blackout period" approach which would prevent RI securities being traded by insiders during specifically sensitive periods, such as prior to earnings releases, it must be cautioned that such an approach does not help a great deal with ad hoc material change-based disclosure, because of the unpredictability of knowing in advance what the appropriate period would be.

With respect to such ad hoc material changes, the ITTF recommended that there be an enforceable obligation to inform RS in a timely manner, at RS's request, about the possibility of material events occurring. The purpose here is to assist in RS's surveillance activities. This proposal should be distinguished from a pre-notification requirement, which would involve the RI providing advance notice to RS that it was about to make a material change disclosure, or alternatively providing RS with a copy of a confidential material change report being filed with securities regulators, so as to enhance RS's ability

[76] Task Force at p.17.

to monitor trading in that RI's securities. We understand that the TSX is considering amending its timely disclosure policy to include a requirement for RIs to copy RS on any filing of a confidential material change report. Meanwhile, the ITTF's proposal may rather be dubbed a pre-pre-notification requirement, it that it suggests notification to RS before a material change has completely crystallized. If issuers fail to cooperate with a request for information from RS about potential material changes, this may well stem from a fear of losing control over the timing and content of their disclosure processes. However cooperation with regulators' request for information must be considered a core element of ethical market behaviour by RIs.

An even broader possibility is the introduction of an obligation to inform RS about potential material changes, even in the absence of a request for information from the regulator itself. A potential problem here is the possibility that RS would be inundated with material about future RI material changes, which may not in fact ultimately come to fruition. We suggest, therefore, that such a routine pre-pre-notification requirement should not be made mandatory at this point, but that RIs should be encouraged to make best efforts to engage in a practice of notifying RS in advance about potential material changes, even in the absence of a request from the regulator and once a reasonable threshold of the likelihood of their occurring had been reached.

Recommendation #16: The content of an IT policy should not be mandated by regulators, though it most likely should include the introduction of routine "blackout periods". It should also provide some indication of how the issuer proposes to monitor ongoing adherence to its internal policy.

Recommendation #17: RIs should be encouraged to include, as an element of their IT policy, an undertaking to make best efforts to inform RS of potential material changes that are reasonably likely to occur.

b) Supporting Enhanced Compliance with Internal Policies

Knowledge of Requirements

The OECD's regulatory compliance report noted that "Studies in both Hong Kong and Australia show that few company directors have a sound, or even basic, understanding of their obligations under companies and securities regulation[77]". Similar studies have not been undertaken in Canada, and high-profile media attention has been directed to the question of insider trading. Nonetheless, it is still possible that those who would be designated as being in "a special relationship with the reporting issuer[78]" and therefore susceptible to the insider trading prohibition may be unaware of the nature and scope of the prohibition. An IOSCO report on the need for educating market participants about unacceptability of the practice of insider trading was endorsed by the CSA in its ITTF report[79]. While the broad outlines of the prohibition are straightforward, there is some complexity attached to the assessment of when the information in the possession of someone in a special relationship is sufficiently "material" to be disclosed, or in any event to prevent the insider trading[80]. Although there are pervasive rule design issues with respect to the slippage between the definition of a "material fact" and a "material change" in most Canadian securities legislation[81], we would argue that it is primarily the role of organizations to apprise their officers and employees of these requirements and to assist them with cognitive appreciation of the nuances of when and how the requirements apply. However the ITTF reviewed the compliance manuals of "several major Canadian investment dealers" and found only one that included guidance for employees on best practices for information containment. This is despite the fact that OSC Policy 33-601 has been in place since 1998.

<u>Recommendation #18:</u> Issuers and registrants should better educate their officers and employees about the parameters of insider trading, such as when information is sufficiently "material" to trigger the insider trading prohibitions. Issuers should also engage seriously in an ethics building process with respect to insider trading.

Organizational Monitoring of Compliance with Internal Policies

Assuming that issuers and registrants comply (if they have not already) with a requirement to establish an insider trading policy that clearly establishes insider trading as a prohibited activity, how much should

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[77] OECD report at 14.
[78] OSA s.76.
[79] Task Force *supra* at 27.
[80] The Donnini decision with respect to application of the "probability/magnitude test" is a good example of this complexity.
[81] This issue is being pursued by another research study commissioned by the Task Force, to be prepared by Professor Janis Sarra. See also Mary Condon, *Ideas and Interests in Ontario Securities Regulation*, University of Toronto Press 1998, and comments on this issue from the Five Year Review Committee report made to the Ontario legislature in 2003. Note also that the TSX imposes heightened disclosure requirements, involving "material information" on listed issuers

issuers be expected to monitor the trading activity of their officers or employees on an ongoing basis[82]? Issuers might well argue that it is simply too difficult to monitor actual compliance with internal policies around insider trading, given the incentives for individuals to conceal their activity. This seems like a less than satisfactory response given the public concern about the practice. A better approach might start with the acknowledgement that the existence of a practice of insider trading within an issuer firm poses significant risk for that issuer, not just of regulatory sanction but of reputational damage as well. On the other hand, given the concerns expressed about insider trading by investors, issuers that became known as "compliance leaders"[83] in this area might be expected to reap reputational rewards.

Consideration of the issue of monitoring by issuer firms for compliance with insider trading policies should distinguish between the situation of issuers and registrants. Issuer firms will be concerned with monitoring trading by their officers and employees in the issuer's own securities. Registrant firms will have a broader ambit of concern, given the scope of the information about RIs generally that might be available to those whose activities they are concerned about. In both cases, however, Langevoort's observation that internal supervision mechanisms may take the form of either aggressive monitoring or ethics building is illuminating. He notes that the difficulty with aggressive monitoring might be that it stimulates mistrust of the firm among employees, i.e. there will be "lower rates of compliance as a result of turning up the heat[84]". Thus firms might be likely to choose "compliance structures in which the values of motivation and cohesion (not to mention worries about out-of-pocket costs) often trump high-powered monitoring, thus opting for higher compliance risk because it is the most sensible strategy"[85]. This suggests that it is incumbent on firms at least to engage seriously in an ethics building process with respect to insider trading, with the possibility of more aggressive monitoring being instituted later.

Yet, a further aspect of this issue, as it relates to RIs, involves the controversial matter of the forms of compensation provided to an issuer's senior officers or directors, since often the vehicle for insider trading is awarding or cashing in stock options[86]. It is a truism to say that if compensation were less frequently given in the form of issuer securities, there would be less opportunity for insider trading and less of a need for RIs to engage in monitoring the trading activities of their employees. At the least,

[82] It must be acknowledged that the broad definition of "special relationship" in the legislation means that it is not by any means only officers, directors or employees of RIs or registrants who may be guilty of insider trading, though effective monitoring of the activities of these groups would be a very good start.
[83] OECD report at p.35.
[84] Donald Langevoort " Monitoring: The Behavioral Economics of Corporate Compliance with Law" 2002. 71 Columbia Business Law Review 71 at 98.
[85] Langevoort at 103.
[86] For examples see the Pezim and Harper cases.

rigorously allocating responsibility to a designated officer within a firm to monitor the exercise of stock options would be a significant component of a firm-based strategy for preventing insider trading. This should, in our view, encompass a requirement not to exercise stock options without the written approval of the designated monitor, and verification by the exerciser of the options that he or she has no knowledge of material undisclosed information.

In this respect, it should be noted that s. 613(j) of the TSX 's Company Manual indicates that

> "listed issuers may not set option exercise prices, or prices at which securities may otherwise be acquired, on the basis of market prices which do not reflect material information of which management is aware but which has not been disclosed to the public"

In October 2005 the TSX issued a notice reminding listed issuers of these provisions, and indicating that the TSX "will not permit options to be granted" if material information has not been disclosed. The notice also "cautions listed issuers about granting options during a blackout period"[87], and indicates that the TSX will be prepared to mobilize the sanctions available to it (requiring options to be cancelled, forfeited or repriced, or issuer suspension or delisting) where options have been granted while material information is undisclosed.

Recommendation #19: Issuers should give serious consideration to developing ongoing monitoring capabilities in the area of insider trading, especially with respect to the granting or exercise of stock options. This could include the appointment of a senior officer with responsibility for approving the exercise of stock options.

Technological Innovation and the Role of RS

It is clear that the ability to use technological tools to monitor the identity and activity of traders in reporting issuer securities is a crucial complement to efforts by issuers to monitor the activities of their own staff or members. Technological surveillance strategies can be embedded in the activity of trading itself, for example by the ability to discern unusual trading patterns in a security where public announcements have been made or are imminent. In this sense the integrity of the regulation of insider

[87] "Staff Notice to Applicants, Listed Issuers, Securities Lawyers and Participating Organizations" #2005-0003, October 24, 2005

trading is highly dependent on the surveillance and analysis activities of RS. We have discussed above the recommendation of the ITTF that issuers be required to provide additional support for RS's efforts by introducing an enforceable obligation on them to provide RS with advance notice of material events, to facilitate RS's monitoring activities.

In addition to such developments, we suggest that RS disseminate more broadly, information about the sensitivity and reach of its technological capacity for detection of incidents of insider trading, as a potential deterrent to those who might be otherwise tempted to engage in the activity. We would also support putting resources into investigating whether the role of technology in this area could be enhanced by a greater ability for trading platforms to block altogether transactions that might be suggestive of insider trading taking place, such as the purchase or sale of securities with limit prices significantly outside of recent trade ranges for that security. We have noted already the analogy applicable in the short selling case, whereby the trading platform will not allow the entering of a short sale order on a down tick, as such a short sale is prohibited under UMIRs rules. In this regard, it is important to point out that markers designating trades as insider trades must be provided by dealers to RS, though these are not disclosed publicly. Indeed, the ITTF had recommended that such insider trading markers be publicly disclosed in real time. The existence of the requirement of disclosure to RS does not, of course, prevent insider traders from evading it, for example by having the trades originate from the accounts of cooperative non-insiders or from offshore. In this respect, RS is heavily reliant on monitoring engaged in by IDA members conducting trades on behalf of clients. In accordance with a recommendation of the ITTF, RS and the IDA have developed a set of "insider trading red flags", which were promulgated to members in November 2005[88].

Meanwhile, we endorse the recommendation about real time disclosure of legal insider trading made by the ITTF [89]. As well as providing more useful, time-sensitive information to investors generally, this innovation would serve to signal to insider traders the importance regulators accorded to the disclosure and monitoring of their trading activities.

<u>Recommendation #20:</u> Additional regulatory resources should be devoted to the enhancement of technological tools for detecting or preventing insider trading activities.

[88] IDA Member Regulation Notice "Guidelines for Confidential Information Containment" November 18, 2005
[89] See ITTF report at p.20.

<u>Recommendation #21:</u> Insider trading should be disclosed publicly in real time, as a further deterrent to illegal insider trading and to enhance the market information available to retail investors.

The Role of the Regulator

Securities commissions are heavily dependent on the detection abilities of RS to obtain information about potential infractions of the IT prohibition that they may proceed to investigate. The issue for us is whether there is a role for public regulators to play in attempting to prevent the practice in the first place. Given the general popularity of risk-based assessment in the regulatory enterprise, it would not be surprising to argue for such a strategy in terms of how public regulators handle the issue of insider trading. With respect to issuers, for example, it seems plausible that SMEs might be a greater source of risk of insider trading practices for a variety of reasons, not least of which are their likely greater difficulty in educating their employees about the prohibition, and their greater likelihood of compensating by way of stock options. We argue that regulators should concentrate some compliance resources with respect to IT on ensuring that SMEs in fact introduce appropriate internal IT policies and have an internal strategy for monitoring its effectiveness.

More generally, regulators have a useful role to play in building issuer capacities to monitor or educate their employees about legal requirements[90]. They are also the best entity to engage in measurement of compliance rates and monitoring of how preventive strategies are working across the issuer and registrant community. In the IT context, this would involve commissions gathering data at two levels: identifying who has introduced insider trading policies, and analysis of RS trading data to see if any patterns emerge with respect to the characteristics of the high-risk actors or institutions engaging in IT.

<u>Recommendation #22:</u> Regulators should adopt a risk-based approach to monitoring and surveilling RIs for compliance with enhanced insider trading requirements.

[90] See Black article supra.

6. Case Study #3: Primary Market Disclosure

i. Introduction

Businesses have the ability to access significant pools of capital through the public markets in Canada. In 2005, a total of $42.16 billion was raised through 436 transactions in the Canadian capital markets. IPO activity accounted for 139 deals with a value of $15.97 billion while public issuers making subsequent offerings accounted for the other 297 deals with a value of $26.19 billion.[91]

The raising of capital in the public markets is of critical concern to securities regulators in Canada. The prospectus has historically been considered *the* fundamental securities document in the issuance process and has been the focus of much of regulatory attention. Some would say that there has been too much focus on primary market disclosure, including the past Chair of the OSC: "Historically, in matters of corporate finance, securities law and regulatory practice has been pre-occupied with the qualification of new issues under the prospectus system, with far too little focus on maintaining a current record of quality information about an issuer".[92]

Continuous disclosure is the subject of the following case study. The purpose of this case study is to explore the compliance tools and strategies used in the context of the primary market disclosure and to assess their effectiveness. This case study considers the impact of developments such as: the move away from the use of the long-form prospectus to the short-form prospectus and other more streamlined prospectuses; and the market shift away from the primary market to the secondary market (90% of all securities transactions take place in the secondary market)[93] and the related regulatory focus on continuous disclosure and an integrated disclosure system.

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[91] Data from ScotiaCapital Investment Banking. The breakdown of the $42.16 billion is as follows:

- Common Equity: $10.19 billion in 182 transactions. IPO activity accounted for $1.81 billion in 24 IPO transactions involving common equity.
- Preferred Shares and Structured Products: $13.25 billion in 89 transactions IPO activity accounts for $8.82 billion in 72 IPO transactions involving preferred shares and structured products.
- Income Trusts: $18.73 billion in 165 transactions. IPO activity accounts for $5.34 billion in 43 IPO transactions involving income trusts.

[92] David Brown, 1999: http://www.osc.gov.on.ca/About/Speeches/sp_19991026_db_dialogue.jsp

[93] Ibid.

ii. Strategies for Ensuring Full, True and Plain Disclosure of All Material Information in the Prospectus

The prospectus is required for IPOs, other primary offerings of securities and in some cases, secondary offerings. The prospectus contains mandated disclosure of information and attempts to reduce information asymmetries as between issuers and investors. It also serves as a useful tool to assist market participants to price securities accurately. Securities laws require that the prospectus must provide full, true and plain disclosure of all material facts. What policy tools and strategies are currently employed to ensure that issuers, do, in fact, provide full, true and plain disclosure in the prospectus? We list several significant ones below.

Securities Laws, Regulations and Policies:

- To give some meaning to the phrase full, true and plain disclosure, securities law rules set out requirements for specific information that must be contained in all prospectuses. [94]
- Securities law rules also impose specific requirements for prospectus disclosure for certain types of issuers and/or securities.[95]
- The CSA also issues guidance on their expectations in relation to prospectus disclosure for certain types of securities, most recently in relation to income trusts.[96]

Certification by Senior Management and Directors:

- The prospectus must be certified by the CEO, the CFO and any two directors of the issuer that the prospectus constitutes full, true and plain disclosure of all material facts.

Gatekeeper Involvement and Certification:

- Underwriters: The underwriter(s) must also certify that to the best of its knowledge, information and belief, the prospectus contains full, true and plain disclosure of all material facts.
- Auditors: The auditor must certify that the issuer's financial statements have been prepared in accordance with generally accepted accounting principles.
- Lawyers: While lawyers are not required to certify the prospectus, their involvement conceivably imposes additional discipline on the issuer.

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[94] See, for example, OSC Rule 41-501, General Prospectus Requirements (2000), 23 OSCD (Supp.)).
[95] See for example, National Instrument 41-502 Prospectus Requirements for Mutual Funds.
[96] For example, see CSA Staff Notice 41-304 - Income Trusts: Prospectus Disclosure of Distributable Cash (August 2005); See also the National Policy 41-201 Income Trusts and Other Indirect Offerings.

Regulatory Vetting of Preliminary Prospectus:

- Securities regulators have the opportunity to vet a preliminary prospectus during the waiting period, which is the period between when the receipt is issued for a preliminary prospectus and when the receipt is issued for a final prospectus.
- The Director can refuse to issue a receipt for a final prospectus if the director determines that the prospectus contains a statement, promise, estimate or forecast that is misleading, false, or deceptive. The Director also has discretion to refuse to issue a receipt if the proceeds of the sale are insufficient to achieve the intended purpose.[97]

Public Sanctions:

- Securities laws create an offence for failure to file a prospectus and also failure to deliver a prospectus without the regulator having issued a receipt for the prospectus.
- Securities regulators can cease trade or cancel or restrict a party's registration for failure to comply with the prospectus requirements.
- Some provincial regulators have the authority to order the person in violation of the prospectus requirements to resign or be prohibited to act as a director or officer.

Investor Remedies:

- A remedy of rescission for misrepresentation in a prospectus and/or a right of action for damages is also available to investors.

We now analyze the effectiveness of some of these strategies or approaches.

Securities Laws, Regulations and Policies

In the context of particular securities law rules that relate to primary market disclosure, our first observation and recommendation relates to the definition of material fact. The requirement that the prospectus contain full, true and plain disclosure of all material facts is critical to securities regulation. Currently, the definition of material fact differs across provincial securities legislation, with some provincial acts containing a forward-looking provision and others containing a forward- and backward-looking component. The *Quebec Securities Act* requires disclosure of all material facts that are likely to

[97] See OSC s.61, for example. See also Loki Resources Ltd. (1984) where the OSC refused to issue a receipt. See also Tricor Holdings (1981) where the director refused to issue a receipt for an issuer which had previously been controlled by an individual with a serious criminal record.

affect value or market price of the security, without a qualifier or threshold of "significance" as in the other acts. We recommend that a uniform definition of "material fact" be adopted across the country in the interests of ensuring compliance with the prospectus requirements.

Our second observation and recommendation relates to the distinction between material fact and material change. Securities acts require disclosure of any material change after a receipt has been issued for the final prospectus but before the distribution is complete. This issue was significant in the *Danier* case where the Ontario Court of Appeal confirmed that the obligation to amend a prospectus relates only to material changes and not to material facts.[98] To the extent that technical distinctions can be drawn between these two terms, allowing issuers to withhold material information during the primary issuance process, we urge the Task Force to consider ways in which this definitional loophole may be closed.

Finally, our review of a sample of prospectuses filed in 2005 asks us to question whether there is compliance with the requirement that the prospectus contains "plain" disclosure of all material facts. Our review found technical, boilerplate language that would be difficult for many unsophisticated investors to comprehend. We fully endorse the other research studies commissioned by the Task Force, which recommend that disclosure documents be simplified and written in plain English.

<u>Recommendation #23:</u> A uniform definition of material fact should be adopted across the country in the interests of ensuring compliance with the prospectus requirements. The distinction between material fact and material change should be eliminated.

Regulatory Vetting by Securities Regulators

The waiting period provides an opportunity for regulators to review the prospectus and determine whether it complies with securities laws requirements. However, not all prospectuses that are filed are reviewed by securities regulators.

There are several possible levels of review. Using the typology in the OSC's 2005 Corporate Finance Annual Report, there is first the *Screening Review* during which senior lawyers and accountants screen prospectuses to determine whether the prospectus should be subject to a *Full Review*, *Issue-Oriented Review* or *Basic Review*. A *Basic Review* is largely limited to an administrative processing of the

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[98] The Supreme Court of Canada recently granted leave to appeal in the Danier case.

document. A *Full Review* involves a complete review of the prospectus and any documents incorporated by reference. An *Issue Oriented Review* focuses on specific legal, accounting or other regulatory issues.

In fiscal year 2005, the OSC engaged in 300 Basic Reviews, 121 Full Reviews and 66 Issue-Oriented Reviews, for a total of 487 reviews. (These numbers are not significantly different than the breakdown from previous years.) Of the 187 *Full* or *Issue-Oriented Reviews*, 101 involved long-form prospectuses, 71 involved short-form prospectuses and 15 involved rights offerings circulars.

Excluding the 300 *Basic Reviews* of prospectuses, the prospectuses reviewed by Corporate Finance accounted for approximately 36% of all prospectuses filed in Ontario.[99] The reviews also represented 29% of all issuers whose head office is located in Ontario, and for which Ontario would likely be the principal regulator under MRRS. 67% of the issuers reviewed under *Full* or *Issue-Oriented Review* were listed on the TSX.

Given the existence of multiple securities regulators and the existence of the MRRS, we suggest that securities regulators adopt a policy that they will engage only in a *Full Review* or an *Issue-Oriented Review* of those issuers' prospectuses for which they are the principal regulator under MRRS. They should engage in a *Basic Review* for all other issuers, leaving the possibility of a more rigorous review by the principal regulator.

It appears as though, based on the OSC's data, the OSC has engaged in *Full* or *Issue-Oriented Review* generally only of issuers who have the OSC as their principal regulator. We do not have data from the other commissions on this point, but we encourage this approach by all the regulators, on the basis of efficiency and best use of limited resources.

The OSC Corporate Finance report states that prospectuses relating to IPOs receive full review as do those that score high on their risk-based profile. The OSC's Staff Notice 11-719 outlines its risk-based approach to prospectus review. It states that "the objective of the selective review system is to focus limited staff resources on material and relevant issues, thereby facilitating an effective and cost-effective review process". The prospectus review criteria used by OSC staff, as set out in OSC Staff Notice 11-719, relate to risks under four categories: Issuer's Corporate Structure and Underlying Business; Issuer's Financial Conditions or Results; Nature of Offering; and Matters Related to Advisors or Corporate Governance.

[99] OSC Corporate Finance Report 2005.

It used to be that the short-form prospectus allowed for a streamlined primary issuance process for seasoned issuers who had a significant public disclosure record and large market capitalization. The theory was that investors would be protected because of market scrutiny of the public disclosure record as well as securities regulators' prior vetting of the continuous disclosures. However, NI 44-101 now allows a broader range of public issuers to access the short-form prospectus by having done away with the seasoning and market capitalization requirements.

To the extent that that streamlined prospectuses are less likely to receive a *Full Review*, we are relying heavily on the efficacy of market- and law-based strategies that ensure accurate and timely continuous disclosures. However, in light of the changes to the short-form prospectus rules, we question whether the market mechanisms (i.e. research analysts) that assist in scrutinizing and verifying the pubic disclosures of larger, more-seasoned public issuers are as effective in the context of smaller, less-seasoned public issuers. This should put more pressure on the securities regulators to engage in a vetting of short-form disclosure documents that are filed by smaller, less-seasoned issuers.

As well, the waiting period for the short-form prospectus is generally much shorter than for the long-form prospectus. National Policy 43-201 (1999), 22 OSCB 7308 requires the principal regulator under MRRS to use its best efforts to issue a comment letter on the preliminary short-form prospectus within *three* working days after the issuance of the preliminary MRRS decision document (receipt). Non-principal regulators are supposed to communicate their comments by noon on the working day after the principal regulator releases its comments. Even if the principal regulator engages in a *Full* or *Issue-Oriented Review*, the depth of the review possible in three days is limited.

<u>Recommendation #24:</u> Regulators should engage in full or targeted review of only those prospectuses for which they are the issuer's principal regulator under MRRS, so as to expend their resources efficiently and avoid duplicative review.

Gatekeepers

The involvement of gatekeepers such as underwriters and auditors is viewed, overall, as adding integrity to the public issuance process. The underwriter's involvement in developing the offering and drafting the preliminary prospectus with the issuer (together with liability for same) should give public investors a greater level of confidence that the prospectus contains full, true and plain disclosure. As was stated in the decision in YBM, an underwriter is a "gatekeeper of the public interest with professional expertise in the capital markets….An underwriter must go beyond the statements of the issuer's directors, officers and counsel and must avoid automatic reliance".[100] The decision continues by stating: "An underwriter must challenge the disclosure the issuer proposes to make to the investing public….Lead underwriters must be adversarial".[101] Similarly, the requirement for audited financial statements should allow investors a heightened degree of comfort in the financial health of the company as reflected by the financial statements.

While private gatekeepers can provide assurances to investors, they also face significant conflicts of interest.[102] Some conflicts are left to market forces to sort out; others are addressed by securities regulators directly through bright-line prohibitions or other rule design. In the context of underwriting, for example, provincial securities regulators have created National Instrument 33-105, Underwriting Conflicts (2001), 24 OSCB 7687 and the IDA has promulgated Policy 11 on research analysts. Similarly, in the context of financial disclosure and the role of auditors, recent securities regulatory reform has focused on, amongst other things, independence requirements for auditors, the composition of the audit committee and its relationship to the auditors, and the creation of CPAB - an oversight body that inspects accounting firms that audit public companies.

In this study, we do *not* analyze in any detail into how the gatekeeping functions of underwriters, auditors and others may be improved because we understand that separate studies have been commissioned by the Task Force on the topic of gatekeepers and their effectiveness. However, we do note that regulators place significant weight on the involvement of gatekeepers in the issuance process in deciding what level of review they should conduct on an issuer's prospectus. For example, OSC Staff Notice 11-719 notes as a risk factor whether the "issuer has not engaged an underwriter to perform due diligence in connection with the offering", which suggests that something more than a basic review of the issuer's prospectus is likely warranted. Similarly, in the YBM case, it was noted that OSC staff "were not prepared to issue a receipt for a final prospectus until YBM's income statement was confirmed by a 'Big Six' accounting firm".[103]

It should be noted that underwriters are not involved in the verification of an issuer's disclosure on a continuous basis in the same way that they are involved in the traditional long-form prospectus process.

[100] YBM Magnex International (2003), 26 OSCB 5285.
[101] Ibid.
[102] "If the independence of one's mandate is threatened, then the reasonableness of one's judgement becomes questionable". Ibid.
[103] Ibid.

To the extent that there is a move to an integrated disclosure document or a continuous market access model which would limit or do away with the prospectus, we suggest that the Task Force consider ways in which other tools and strategies can be strengthened to fill the void that underwriters currently play. This might include more frequent or in-depth regulatory reviews as well as ensuring that private liability mechanisms are adequate.

<u>Recommendation #25:</u> In light of the liberalization of the short-form prospectus eligibility requirements, securities regulators should engage in more frequent and more in depth vetting of short-form prospectuses (and continuous disclosure records) of those issuers who are not as closely followed by market participants such as research analysts.

7. Case Study #4: Continuous Disclosure (CD)

i. Recent Regulatory History of the CD Issue

Finding a regulatory approach that produces optimal levels of CD is crucial to a thriving securities market, since as has been frequently pointed out, more than 90% of securities take place in secondary markets as opposed to primary markets. Investors, whether individual or institutional, are much more likely to interact with the secondary market on a consistent basis than they are with the primary market and are therefore much more likely to have an experience-based opinion about its integrity[104]. There has developed a widespread view among U.S. and Canadian regulators over the last several years that investor opinion as to the integrity of the secondary markets was adversely affected by media and other reports about disclosure inadequacies at U.S. companies like Enron, WorldCom, Adelphia and others. This premise prompted the promulgation and implementation of legislative requirements such as the Sarbanes-Oxley Act of 2002 (SOX), and CSA rules modeled on SOX[105]. We summarize the constitutive elements of this ongoing rule design effort in Canada below, bearing in mind that other research studies sponsored by the Task Force will analyze this rule development process in detail.

Although, as with the insider trading issue, we have not yet seen in Canada high-level prosecutions similar to those that have accompanied the financial downfall of companies like Enron or Adelphia in the U.S.[106], we have begun to see a trickle of regulatory enforcement actions in provinces like Ontario[107]. Interestingly, some of these have involved the regulators requiring issuers to conduct reviews of their disclosure requirements as part of an OSA s. 127 sanction. At the same time investors have been provided with another avenue of legal redress for inadequate CD disclosure by issuers in the shape of the recently-proclaimed Part XXIII.1 of the OSA. This is designed to provide a more favourable statutory liability regime for investors suing issuers for various CD failures. Ultimately the concern of this section of our study is an assessment of the strengths and limitations of a compliance-oriented approach to promoting good CD practices in Canadian securities markets.

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[104] Nor is there much dispute that CD contributes to the overall efficiency of securities markets, though there is of course contestation about how much information is enough.
[105] This perspective on the part of legislators and regulators has not gone unchallenged in the academic literature. See Roberta Romano "The Sarbanes-Oxley Act and the Making of Quack Corporate Governance" (2005) 114 Yale Law Journal 1521. The issue is also being addressed by other research studies sponsored by the Task Force.
[106] Though these prosecutions have not necessarily targeted disclosure inadequacies.
[107] See decisions like *YBM; Miller and Bernstein; Agnico-Eagle.* The investigation currently underway into the activities of Royal Group Technologies may provide a prosecutorial dimension to the regulatory response to CD deficiencies.

ii. CD Rule Design in Canada

As indicated, much of the recent intensity of CD regulation in Canada has been located at the rule-design level. While the statute itself has historically contained rules about continuous and timely disclosure (e.g. OSA s.75), more recent examples of completed and incomplete rule-design efforts in this area include the following national or multilateral rules:

- NI 51-102: this instrument, promulgated by the CSA in 2004 harmonizes the rules relating to types of CD material required of reporting issuers in Canada. It restates, or in some instances, enhances provincial legislative requirements relating to material change disclosure and annual and interim financial statement requirements, harmonizes provincial requirements with respect to annual and interim Management, Discussion and Analysis documents (MD&A), establishes an Annual Information Form (AIF) requirement for non-venture issuers and a Business Acquisition Report (BAR) requirement. As we note elsewhere in this report, passage of this harmonized rule provided the platform for extending the opportunity to file short-form prospectuses for financings to reporting issuers generally.

- NI 52-108: one of the so-called CanSox initiatives, this rule establishes the Canadian Public Accountability Board (CPAB), which enters into participation agreements with accounting firms before they may be engaged to provide audit services to reporting issuers, and which monitors the "quality-control systems" of these firms.

- MI 52-109: this provision requires annual and interim certificates to be filed by CEOs and CFOs[108] of reporting issuers that certify that issuers' annual and interim filings do not contain a misrepresentation. The filings further certify that these individuals have established and maintained both "disclosure controls and procedures" and "internal control over financial reporting" to provide "reasonable assurance" concerning knowledge of material information about the issuer and concerning the reliability of financial reporting. The effectiveness of the disclosure controls and procedures is also required to be evaluated[109]. These requirements came into effect for financial years ending on or after March 31, 2005. Significantly, the rule does not prescribe any specific policies and procedures that must make up either of these control

[108] Or their equivalents.
[109] CSA Notice 52-313, dated March 10, 2006 indicates that the CSA proposes to expand MI 52-109 to include certifying that an evaluation of the effectiveness of the issuer's internal controls over financial reporting has been undertaken, with respect to financial years ending on or after December 31, 2007.

mechanisms, and it is quite clear about the fact that "these considerations are best left to management's judgement"[110].

- MI 52-110: this rule enumerates a set of responsibilities and authority for the audit committees of reporting issuers[111], and establishes financial literacy and independence criteria for members of audit committees[112].

- Proposed MI 52-111: this proposed rule would have required that management evaluate the effectiveness of its internal control over financial reporting "against a suitable control framework" and have that assessment audited. In March 2006 the CSA indicated that proposed MI 52-111, which was "substantially similar" to the requirements of the SOX Act, s.404, would be withdrawn. This decision was the result of "extensive review and consultation and in view of the delays and the debate underway in the U.S over the rules implementing section 404 of the *Sarbanes-Oxley Act of 2002*[113]*"*.

- NI 58-101: this rule requires disclosure of important aspects of the reporting issuer's corporate governance practices to be provided in an issuer's AIF or management information circular[114]. The rule does not prescribe what corporate governance practices would be appropriate with respect to any of these matters, but its accompanying policy does provide guidance about corporate governance best practices[115].

The OECD's regulatory compliance report advocates that appropriate rule-design is the first step in a comprehensive compliance strategy. Yet there remain some opaque areas for the regulated community at this stage of the compliance process. This is especially the case with respect to the definition of "materiality" and the extent to which business judgment will be persuasive in this context[116]. To the extent that ambiguity about the definition of a "material change" under securities law is an operating factor in RI failures to make timely disclosure of material information, it is clearly a significant shortcoming in the legislation. More generally, we have noted that there has been some contestation about

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[110] NI 52-109 CP Part 6.
[111] Other than those reporting issuers specifically exempted by MI 52-110 s.1.2.
[112] These membership criteria do not apply to audit committees of venture issuers.
[113] CSA Notice 52-313 (2006) 29 OSCB 2011.
[114] Such practices include; independence of board members, process for compensating board members, board mandates, education of board members, the existence of codes of conduct for board members, officers and employees.
[115] See NP 58-201 (2005) 28 OSCB 5383
[116] See the Ontario Court of Appeal decision of Kerr v. Danier Leather Inc. 77 O.R. (3d) 321

the appropriateness of the CanSox rules introduced, with respect to the costs they impose on all issuers and the demonstrated need for their existence, which debate has apparently resulted in the withdrawal of proposed MI 52-111. It is outside the scope of this study to enter fully into that debate, though it is necessary of course to acknowledge that the perceived legitimacy of the rules that market participants have to comply with is an important factor in the achievement of robust compliance rates. Thus it has been suggested that the importation of S-Ox regulatory requirements into Canada may encourage the development of a "loophole-conscious, rules-based culture" to the detriment of cultures of compliance[117].

iii. Current Compliance Strategies Used with Respect to CD Requirements

a) From Rule Design to Compliance

Observers of regulatory policy-making point out that, following an intensive period of rule design, it is crucial to follow up by monitoring the implementation of complying practices by the regulated community, or the credibility of regulators risks being undermined[118]. It is also axiomatic that it may be problematic to proceed immediately from rule design to the imposition of serious sanctions, given the inevitable time-delay associated with the regulated community becoming conversant with new requirements and building organizational capacity to comply. This suggests that in many instances where new rules are introduced, lower-visibility and less-adversarial compliance monitoring by the regulator is the most appropriate next step. Such compliance monitoring also, of course, provides the regulator with useful systemic information about the extent to which the regulated community is indeed complying on the ground with existing and new rules.

b) What Do We Know About Compliance Rates with CD Requirements?

Obviously there were robust CD requirements in place, covering annual and interim financial reporting, AIF/MD&A disclosure and timely disclosure of material changes, before the CanSox initiatives were introduced. Many would argue that the current emphasis on new rule design in Canada in the CD area has not been evidence-based, in the sense that regulators have not adequately demonstrated widespread deviation from CD-compliant practice. Some information about CD compliance levels exhibited by reporting issuers in Ontario is available from the OSC Corporate Finance Staff's annual reports on continuous disclosure. OSC staff began issuing these reports in 2000, following the creation of a

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[117] See Ronald B. Davis "Fox in SOX North, A Question of Fit: The Adoption of United States Market Solutions in Canada" [2004] Vol XXXIII *Stetson Law Review* 955 at 990.
[118] See OECD report at p.19-21.

continuous disclosure team within that branch of the Commission. Even more recently the CSA has begun to also issue annual reports on CD compliance issues. The evidence available from these reports is considered in more detail below.

We also observe that the recently-published B.C. Securities Commission's Service Plan for 2006-2009 indicates that one of the objectives of the regulator in the near term will be to determine "how pervasive disclosure failures are among B.C.-based issuers". [119] To determine this, the B.C. Commission plans to apply risk-based criteria related to disclosure failures to a pilot group of the most significant B.C.-based issuers. This pilot program is expected to create a manageable number of leads "for stepped up review by compliance staff… If untimely disclosure is a pervasive problem, we will design outcomes-based compliance tools to reduce the incidence of this problem among B.C. issuers". One feature of this will be to analyze subsequent disclosures of these issuers to demonstrate if the issuer took action in response to the expression of regulatory concerns.

In addition, it should be noted that while it is already a challenging task for regulators to assess the substantive adequacy of disclosure materials filed with them, it is even more challenging to assess the rate at which RIs are failing altogether to disclose material information, either on a periodic or timely basis.

We have outlined already the OECD report's typology of reasons for non-compliance with regulatory requirements. In the specific context of CD disclosure requirements, lack of knowledge of the requirements (with reference to the new CanSOX rules) may well be an operating factor. The ability to comply might be adversely affected by the ambiguity associated with the definition of "material change". More generally, an RI's willingness to comply with periodic or timely disclosure requirements may also be influenced by internal organizational pressures to suppress or delay negative information so as to keep the share price high, or to allow self-interested transactions to occur.

c) Types of Compliance Strategies Currently Being Employed

Firm-Level Compliance

It appears from the 2005 Corporate Finance report of OSC Staff that an "increasing number" of issuers have introduced formal corporate disclosure policies[120]. OSC staff encourages the promulgation of such

[119] British Columbia Securities Commission *Service Plan 2006-2009* at p.27.
[120] OSC Staff Notice 51-706 – Corporate Finance Report (2005) (2005) 28 OSCB 10074 p.10082. This number is not quantified in the report. 395 CD reviews were completed in total in 2005. In a CD disclosure review program report issued in August 2002 (Staff Notice 51-708 25 OSCB 5555), it was reported that 41% of the 517 issuers reviewed had formalized written disclosure policies.

internal policies by issuers, because of its role in "forc(ing) a critical examination of current disclosure practices[121]". However, the same report notes some shortcomings in the drafting and implementation of those policies, with respect to the extent to which they are crafted to reflect the specific issuer's circumstances as opposed to being a restatement of the generalized language of NP 51-201; an insufficiently broad membership for so-called "disclosure committees" that some issuers are establishing; and insufficient attention paid to the detail of the controls to be established by the issuer to support the effective working of the disclosure policy[122].

From a compliance perspective, one of the central substantive goals of the new MI 52-109 is the requirement for reporting issuers to design and certify the adequacy of internal controls over disclosure practices and specifically financial reporting. In this sense the new rule specifically promotes the development and documentation of a compliance orientation within reporting issuers; that is, that they develop internal systems to ensure that their compliance with substantive disclosure and financial reporting rules is appropriate. Thus the rule creates a requirement for issuers to more aggressively address at the organizational level the adequacy of their disclosure[123]. However an equally significant aspect of MI 52-109 is that the content of these disclosure controls is left up to issuers themselves[124]. The question posed by some commentators is whether the development of these internal control systems will become a "check-the-box" exercise, or will rather cause issuers to more radically reorient the priority they accord to disclosure in accordance with the intent of the rule[125]. We take up this issue further below.

CD Compliance Strategies at the Regulatory Level

The CD review program engaged in by the OSC and the CSA collectively serves at least two purposes:

- to closely review the CD filings of a significant subset of reporting issuers and resolve any deficiencies found in those filings using a number of options, as described below
- to provide notice to the regulated community generally of systemic shortcomings with respect to specific CD issues.

[121] Ibid at 10082.
[122] Similar shortcomings were noted by OSC staff when it first (in 2001) began the practice of requesting CD policies for review, if issuers had them.
[123] See CSA Staff Notice 52-313 (2006) 29 OSCB 2011 at 2012 to the effect that "we believe the proposed additional internal reporting requirements will increase management's focus on, and accountability for, the quality of internal control over financial reporting".
[124] NI 52-109CP.
[125] Davis, *supra.*

The vehicle for accomplishing the latter goal is the annual reports issued by both the Corporate Finance branch of the OSC and annual notices promulgated by the CSA on CD issues. More detail on each of these compliance-related functions is provided below.

Compliance Review of Reporting-Issuer CD

The CD review program was introduced by the OSC in 2000, with the goals of increasing awareness of CD issues and effecting greater discipline in the marketplace with respect to CD requirements[126]. The goal established at that time was to review RIs on average once every four years. The percentage of issuers typically reviewed since then has ranged from a low of 19% to a high of 36% (achieved in 2004). However, it is important to point out that the primary reason for higher rates of review appears to be that the absolute number of reporting issuers has been dropping over the last number of years, rather than that increased regulatory resources has allowed reviewers to increase their reach over the pool of reporting issuers as a whole. While speculation as to the cause of this overall downward trend in the number of reporting issuers in Canada is beyond the scope of this study, it seems important to flag it, and to suggest that it may be a source of concern if it is responsive to heightened securities regulatory requirements.

Staff's 2000 report indicated that it had selected issuers for review based on monitoring press articles, complaints from the public and referrals from other OSC branches. More generally, OSC Staff Notice 11-719, establishing the agency's risk-based approach to regulation, canvasses the criteria that are likely to drive the selection of issuers for CD review. They are as follows:

- stock trading activity (including unusual trading patterns, or a significant stock market impact due to market capitalization or trading volume);
- issuer's financial condition or results (the issuer is experiencing financial difficulty, recent restatement of financial results, unusual fluctuations in earnings, significant lawsuit or contingency);
- accounting methods and practices (changes to a significant accounting policy, unusual Canadian/U.S. G.A.A.P. reconciliation, transactions where there are divergent views as to accounting practice);

[126] See OSC Staff Notice 51-703 23 OSCB 4123.

- auditor-related issues (auditor's report includes a qualified opinion or missing information, auditor is terminated or resigns, previous experience indicates that issuer, auditor or directors/officers warrant greater scrutiny); and
- prior regulatory scrutiny (no recent CD scrutiny by regulator, history of prior non-compliance, referral from another regulatory source, public complaints).

Corporate Finance staff continues to reiterate the influence of risk-based assessment in driving the review selection process, indicating that this approach is also broadly popular among other international securities regulators. It provides the flexibility to reorient selection factors as appropriate, particularly where there is controversy around specific accounting or disclosure practices. It has also been suggested to us that regulatory staff have begun to develop more sophisticated methods of undertaking screening of the RI population as a whole in order to identify emerging compliance concerns. One example of this is a screening to examine if RIs exhibit unduly stable earnings patterns over the course of a number of CD reviews. Such a finding might suggest that techniques of "earnings smoothing" are being employed.

More recently, staff have begun to undertake so-called "targeted reviews", which apply to a sample of issuers and relate to a particular industry, or result from policy developments or accounting standard changes. In 2005, targeted reviews focused on whether auditors were registered with the CPAB, reviews of restructuring costs, compliance with requirements to retain a previously granted exemption from NI 51-102, and compliance with the BAR requirements of NI 51-102.

In 2003 and 2004, OSC staff also introduced the innovation of "real-time reviews" for higher-risk companies[127]. Unlike conventional CD reviews, the real-time review file remains open until staff's assessment of the issuer's risk profile changes, and the class of material reviewed is larger, including news articles and press releases, trading patterns, the issuer's website and analyst calls. The advantage of this style of review is that it "may identify patterns of behaviour not as readily evident when looking at an issuer at a specific point in time[128]". RIs are chosen for this form of review as a result of the accumulation of so-called "red flags", including prior restatements of financial results, the complexity of the business model, or prior attention from a regulatory enforcement branch.

[127] Staff undertook 25 of these in 2003.
[128] OSC Staff Notice 51-715 27 OSCB 8653 at 8654.

The OSC's risk-based assessment approach is mirrored by a similar approach taken at a national level, whereby harmonized CSA-level CD review was introduced in 2004[129]. The CSA indicates that its risk-based approach will consider the potential damage that could occur to Canadian capital markets from issuer failure to provide complete and timely disclosure. Interestingly, the CSA does not make its risk-based selection criteria public, with the exception of an indication that they will review large issuers[130] or those that have recently gone public. The former are to be reviewed once every three years; the latter, within twelve months of their IPO. In May 2005, CSA staff announced their intention to conduct a review of a sample of issuers with respect to their compliance with the rules concerning the composition and responsibilities of audit committees under MI 52-110. The outcome of this review has not yet been published.

Notice to the Market Concerning Systemic CD Issues

As well as resolving issuer-specific CD issues that arise as a result of the sampling process, both the CSA and the OSC issue annual reports on their respective CD review programs. These contain general discussion of systemic CD shortcomings uncovered by reviews of individual issuers[131]. Examples of systemic deficiencies that have been raised by these reviews include the executive compensation and retirement benefit disclosure, and disclosure issues in relation to income trusts. In 2005 OSC staff reviewed the filings required by the new MI 52-109 and in general, "found compliance with the requirements of the instrument".[132]

An optimistic note was sounded in OSC Staff Notice 51-712[133], published in 2003, whereby regulators concluded that "overall, we think the standard of disclosure is improving". However some intractable problems appear to persist across several annual reviews, such as revenue recognition and MD&A deficiencies. With respect to revenue recognition, the OSC's 2005 report indicated that many issuers fail to clearly identify the specific triggers for revenue recognition that relate to the various aspects of their operation. Particularly problematic were the recognition of up-front fees and the treatment of "right of return" arrangements. On MD&A, many issuers were placed on the Refilings and Errors lists for MD&A

[129] CSA Staff Notice 51-312 27 OSCB 6475.
[130] Defined as issuers with a market capitalization of greater than $750 million.
[131] For a recent example, see the 2005 OSC Corporate Finance report; also the executive summary of the report on MDA (51-713 at p.1793). See CSA Staff Notice 51-304 on executive compensation disclosure; CSA Notice 51-310 and OSC Staff Notice 51-715 on CD review of income trust issuers; CSA Notice 51-314 on retirement benefit disclosure.
[132] OSC Staff Notice 51-706 (2005) 28 OSCB 10074 at 10083.
[133] 26 OSCB 6123 (2003).

deficiencies, as a result of failures to comparatively analyze their financial condition and results of operation, and failures to disclose factors that caused variation over comparative periods.

Regulatory Options Following CD Compliance Reviews

A variety of outcomes are possible for an issuer following a regulatory review of its CD filings. These outcomes can range from no changes being required to CD material, through commitments from issuers to enhance some aspect of their disclosure in future filings, restatement and refiling of material, to investigation for breach of securities law requirements. In 2005, for example, 80% of outcomes were commitments to enhance future CD filings[134]. In its 2003 corporate finance annual report, OSC staff suggested that they would take the quality of an issuer's corporate governance practices into account in deciding on the interval for a follow-up CD review.

With respect to the minority of issuers required to restate or refile CD material, the OSC created a *Refilings and Errors* list in 2002. This posts names of issuers that restate and refile financial statements or other CD documents, implement accounting or disclosure changes on a retroactive basis, or file documents to correct an earlier non-filing. Once an issuer's name is placed on this list, it is kept on it for three years from the date of filing or refiling.

In OSC Staff Notice 51-708[135], information was provided about the contextual factors used by corporate finance staff to consider if further regulatory action, beyond the correction of deficiencies, is appropriate in any particular case. Such factors include whether or not the issuer self-reported; the extent to which the issuer co-operated with regulatory staff; whether the deficiency was an isolated incident or reflected ongoing poor disclosure practices; if corrective action had been taken with respect to issuer internal reporting processes; and the leadership demonstrated by the board of directors and audit committee.

For reporting issuers who fail to file the appropriate CD material in a timely fashion, close monitoring of defaulting reporting issuers usually results, beginning with letters being written promptly to issuers who have failed to file and the maintenance of a *Reporting Issuers in Default* list, followed up by a management and insider cease-trade order (CTO). If there are large numbers of defaulters, staff may consider further enforcement-based responses.

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[134] OSC Staff Notice 51-706 at 10077. Such a commitment represented 42% of outcomes in 2003

[135] 25 OSCB 5555 (August 2002).

8. Further Steps to Promoting a Compliance Culture in CD

i. Strategies for Regulatory Monitoring of CD Failure

While the risk-based approach to selecting RIs for CD review seems widespread internationally, a sampling/targeting approach may fail to give a comprehensive picture of the state of compliance across the issuer community, and may also operate to insulate RIs from a realistic concern that they may be monitored. More specifically, with the introduction of MI 52-109 and NI 58-101, there is an opportunity for the focus of regulatory compliance reviews to shift to reviewing the adequacy of issuers' internal systems for control and reporting rather than being primarily about substantive reviews of the various types of CD material that is disclosed.

An important compliance-oriented achievement of MI 52-109's requirements is that it could now be possible to do systematic comparisons between a firm's internal disclosure control and reporting system and its actual CD output, to identify more precisely the causes of CD failure. This will only be possible, of course, if regulators can obtain reliable information about those internal disclosure systems. We recommend that regulators should strive to review as comprehensively as possible the internal disclosure control systems in place within RIs, as an important contribution to improving CD practices. They could ascertain information such as the nature of the CEO's involvement in decision-making around disclosure, the extent of an external auditor's review of CD documents, or the processes in place to assure the timeliness and accuracy of material change disclosure or the timely correction of errors. This form of assessment may also provide more robust information with respect to market-wide compliance rates.

<u>Recommendation #26:</u> CD regulatory efforts should be refocused on reviewing internal control systems, as opposed to primarily reviewing the content of specific CD documents.

Meanwhile, there is still a need to develop innovative strategies to deal with the areas of persistent deficiency, such as revenue recognition practices and MD&A inadequacies. Although the nature of the disclosure controls and procedures to be certified by RIs is unregulated, the regulators should provide advice (perhaps in the form of best practice templates for issuers of varying size) about the elements of a successful disclosure control and internal reporting system. It might therefore be most helpful if the advice in this regard was targeted to areas of persistent disclosure deficiency, which as we have seen, include MD&A disclosure and revenue recognition practices, as well as persistent failures to make timely disclosure of material changes. Such best practice templates would likely be developed by the regulators themselves surveying the practices in existence among RI "compliance leaders" and suggesting modifications to them for issuers of different sizes and complexity.

Recommendation #27: **Regulators should enhance RI capabilities with respect to CD by developing a series of best practice templates for successful disclosure control and reporting systems, targeted to areas of persistent CD deficiency.**

ii. Link Between Regulatory Compliance Programs and Enforcement

In the context of the OSC, it appears that frequent and ongoing communication between CD compliance staff and enforcement branch staff takes place. Much of this communication centers on decision-making about regulatory action in specific instances of inadequate disclosure, with corporate finance personnel often collaborating with enforcement staff on the preparation and investigation of enforcement files. In line with the general approach taken in this research, we suggest that there be a greater focus by regulators on the ways in which activities undertaken under the enforcement umbrella can more effectively support the effort to achieve ongoing compliance by market participants with CD requirements. One proposal here would be that sanctioning by regulators should routinely involve orders that RIs review their internal disclosure procedures and controls, with the additional requirement that the results of this review and the action to be taken be reported to the regulator. Compliance staff would then be positioned to engage in more intensive review of the CD output of those firms on a going-forward basis.

Recommendation #28: **Enforcement sanctioning by regulators should routinely involve orders that RIs review their internal disclosure procedures and controls, with the additional requirement that the results of this review and the action to be taken be reported to the regulator.**

Regulators may also wish to consider ways of extending their publicity about the fact that they retain lists of RIs who have refiled, made disclosure errors or defaulted, as a salutary reminder to RIs of the negative consequences of a lack of focus on maintaining appropriate disclosure practices.

Recommendation #29: **Regulators should consider additional publicity concerning the existence and content of the *Reporting Issuers in Default* and *Refilings and Errors* lists that they maintain.**

iii. Enhancing Firm-Level Compliance with CD Requirements

We suggest that, if they have not done so already, it is incumbent on issuers to uncover and analyze their most important sources of internal risk of CD compliance failure. While these sources of risk will be specific to individual issuers, a potentially common one - given recent rule enhancements in this area - will be a lack of employee understanding of the need for internal disclosure procedures and how they should be crafted. Issuers should begin to address their potential deficiencies here, bearing in mind that educative needs may differ depending on the size and complexity of the issuer.

A further endemic source of risk is that organizational routines and incentives themselves may work against the intent of CD rules. Thus it is possible that firms may be tempted to bypass their own procedures or turn a blind eye to failure to abide by reporting or disclosure requirements, for reasons that have to do with competitive business pressures or the need to maintain a high stock price. Strategies that might be considered by firms to signal and maintain their commitment to improving and maintaining appropriate disclosure practices include:

- the introduction or extension of disclosure compliance committees at the board level.

As noted above a number of RIs have begun to establish such committees, though regulators have found that the membership of such committees tends not to be as broadly-based and expert as it might be. Such a sub-committee of the board would signal a high-level commitment on the part of the RI to instituting and monitoring appropriate disclosure routines. Given that recent rule design has intensified the requirements for the audit committee in relation to interim and annual financial disclosure, the responsibilities of a disclosure committee might be more likely to centre on procedures for material change disclosure, along with the approval of acquisition, corporate governance and general AIF disclosure. It would obviously be necessary for a disclosure committee to liaise closely with the audit committee if the membership did not overlap. Ultimately however, securities legislation assigns responsibility for disclosure decisions and practices to the board as a whole.

- the appointment of disclosure compliance officers in RIs, similar to the compliance officer role performed within registrant firms.

As many of the persistent areas of deficiency in CD involve accounting practices, it would be helpful for the incumbent of such a position to have accounting expertise. The appointment of such an individual would help to instantiate a disclosure-oriented culture within the organization on a day-to-day basis. The compliance literature on the operation of such positions at registrant firms suggests that the incumbents of these roles need to enjoy the full support of senior executives of the RI, in order for their activities not to be regarded with suspicion by employees generally. It is of course true that the allocation of the resources to staff such a position will impose additional costs on RIs, especially smaller reporting issuers.

- our review of a sample of certificates required to be filed under MI 52-109 indicates that almost no detail is provided in those certificates about the actual disclosure controls and procedures in operation within RIs, and that the language of the certificates mimics that of the rule's provisions without going any further than that language.

It is unclear therefore to what extent internal procedures are being documented or are actually changing. It is likely more appropriate for such information to be provided in MD&A material that is filed with the regulators, but in line with our recommendation above that regulators now begin to collect data about the nature of the internal disclosure procedures in place among RIs, we suggest that RIs themselves take seriously the need to provide information about the practices they have adopted in this regard.

- it is clear, however, that for disclosure controls and processes to work effectively, they need to be instantiated at all levels of the organization's operations, not just the board level or senior management.

Thus governance experts suggest that risk assessment questionnaires should be routinely administered to employees in individual departments of the firm, or more generally that internal disclosure and reporting procedures should be built into the job descriptions of relevant employees, in order for a disclosure-oriented organizational culture to take root.

<u>Recommendation #30:</u> Reporting issuers should be encouraged to participate in a number of disclosure-related innovations, such as: disclosure sub-committees of the board; the appointment of a disclosure compliance officer at senior management level; and enhanced disclosure in MD&A documents about the existence and nature of internal disclosure control systems.

9. Conclusion

In undertaking this research, we have attempted to assess the power of a compliance-based approach to securities regulation in achieving market integrity outcomes. We have pursued this by focusing on specific areas of regulatory and investor concern, and considering the contribution that a variety of compliance-type strategies could make to resolving intractable behavioural shortcomings in securities markets.

As the executive summary indicates, we have made a variety of recommendations for more effective deployment of compliance tools such as:

- education programmes (abusive sales practices, insider trading and CD);
- mandating written policies (insider trading);
- changing approaches to compensation incentives (abusive sales practices and insider trading);
- support for technological innovation (insider trading);
- changing procedures for regulatory vetting of prospectuses (primary market disclosure);
- enhanced regulatory data gathering and review of RI disclosure and financial reporting procedures (CD);
- regulatory production of templates concerning best practices in disclosure procedures (CD); and
- the appointment of disclosure compliance officers (CD).

While we have suggested specific compliance strategies that seem most compatible with the regulatory area under consideration, we would note that the academic literature on regulatory compliance strategies warns that each method, considered in isolation, has shortcomings[136]. Thus for example, heavy-handed monitoring strategies might de-motivate employees, who sense a lack of trust flowing from their employer. The introduction of written policies needs to be accompanied by detailed ongoing consideration of how to effectively implement the policy. The introduction of new disclosure controls within RIs may impose non-trivial costs. This suggests to us that a comprehensive strategy would involve a mix of the various rule design, monitoring and incentive-based approaches we have outlined above.

Nor should we be perceived as suggesting that traditional sanction-based enforcement has no role in the achievement of market integrity outcomes. Obviously compliance strategies will sometimes fail,

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[136] See OECD report; Langevoort *supra* note 84 at pp. 114-115.

especially in relation to individuals or firms who have no allegiance to the long-term credibility of the capital markets, and regulators need to be able to protect investor interests to the fullest extent possible. However we do argue that reactive sanctioning is by itself unlikely to fully restore and maintain investor confidence in the integrity of capital markets, especially in a world of complex market actors and regulatory resource constraints.

One area we have not canvassed in detail, except with reference to enforcement action around CD failures, is the possibility of combining traditional sanctioning together with ongoing compliance processes[137]. Thus, various jurisdictions have experimented with innovations such as “deferred prosecution agreements” (U.S.) or “enforceable undertakings” (Australia), which feature the deferral of punitive sanctions in return for organizational action to institute new procedures to prevent further legal infractions. A further related innovation is the idea of the so-called “reform undertaking” which would feature, in the context of a regulatory settlement agreement, the retention by a firm of an independent third-party consultant to identify internal compliance failures, report back to the regulator, and tailor appropriate forward-looking reforms to organizational procedures[138].

Such a marriage of enforcement and compliance undoubtedly warrants serious consideration in the Canadian context, though it is possible that there are a number of challenges associated with it. Practically speaking, it may be difficult to find the necessary cadre of third-party consultants who are independent of the firms subject to the reform undertakings and prepared to devote the time and energy to such a project[139]. More generally, this approach is likely to be only a partial solution to the achievement of robust compliance rates within securities markets. A holistic, market-wide approach - rather than an episodic approach - to compliance will be most useful, not least because comprehensive data collection about overall compliance rates is an important way to render regulators themselves accountable for their activities. If compliance rates are low, it behoves the regulator to think more carefully about the design of the relevant rules or the strategies being used to encourage compliance.

Finally, we have noted earlier that a more complete assessment of the relative merits of a traditional sanctioning approach and compliance-based regulatory strategies would require undertaking the challenging task of a full accounting of the costs of compliance, at both the market participant and the

[137] See for example the *CIBC World Markets* settlement agreement with the OSC
[138] For further detail here see Cristie Ford “Toward a New Model for Securities Law Enforcement”.
[139] Ford suggests that they should be “top-flight law firms or high profile individuals”.

regulatory level. Should part of the Task Force's mandate be to identify areas for further research and analysis, we would propose that this issue be taken seriously for the future.

Recommendation #31: **Additional research should be sponsored to provide detailed calculation of the costs of compliance with external regulatory and internal self-regulatory initiatives, as well as its qualitative and quantifiable benefits.**

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