

Northumbria Research Link

Citation: Lokanan, Mark (2015) Self-regulation in the Canadian securities industry: Funnel in, funnel out, or funnel away? *International Journal of Law, Crime and Justice*, 43 (4). pp. 456-480. ISSN 1756-0616

Published by: Elsevier

URL: <http://dx.doi.org/10.1016/j.ijlcrj.2014.11.002>
<<http://dx.doi.org/10.1016/j.ijlcrj.2014.11.002>>

This version was downloaded from Northumbria Research Link:
<http://nrl.northumbria.ac.uk/id/eprint/18556/>

Northumbria University has developed Northumbria Research Link (NRL) to enable users to access the University's research output. Copyright © and moral rights for items on NRL are retained by the individual author(s) and/or other copyright owners. Single copies of full items can be reproduced, displayed or performed, and given to third parties in any format or medium for personal research or study, educational, or not-for-profit purposes without prior permission or charge, provided the authors, title and full bibliographic details are given, as well as a hyperlink and/or URL to the original metadata page. The content must not be changed in any way. Full items must not be sold commercially in any format or medium without formal permission of the copyright holder. The full policy is available online: <http://nrl.northumbria.ac.uk/policies.html>

This document may differ from the final, published version of the research and has been made available online in accordance with publisher policies. To read and/or cite from the published version of the research, please visit the publisher's website (a subscription may be required.)

1. Introduction

Beginning in 2007, the world was shocked by a stock market crash that sent major indices (such as the S&P 500 and the MSCI Index) tumbling. The resulting effect was that investors' portfolios shrank in value, and many asset management firms went into survival mode, while others went out of business. Apropos with the financial crisis, leading financial regulation experts and industry professionals alike blamed the failure on the policies related to self-regulation (Credit Suisse, 2012: para. 1; CFA, 2013: 3). Former Securities and Exchange Commission's (SEC) Chairman, Christopher Cox, conceded that self-regulation of the investment banks contributed to the crisis (Labaton, 2008: para. 1-4). Some even go as far and argue that the "financial crisis resulted from the largely unregulated nature of global financial institutions" (Engobo et al. 2009: 230). While it is difficult to dispute these claims, some degree of introspection is needed to address these assertions of regulatory failure by SROs operating in the securities industry. Framed in relation to the global financial crisis (GFC) of 2008 and the widespread concerns regarding the ineffectiveness of self-regulation in the securities industry, this study seeks to examine the enforcement practices of one such SRO: the Investment Dealers Association of Canada (IDA).¹ The IDA was the national SRO that was responsible for policing investment dealers and their respective Member firms that traded on the debt and equity marketplaces in Canada. The IDA was responsible for setting its own education standards and regulatory requirements. Investment dealers and their respective entities were expected to comply with the IDA's rules, or face sanctions ranging from fines to permanent bans from the Association for non-compliance.

On the basis of an analysis of published data, this study will utilize the SRO's misconduct funnel as it was developed by Brockman and McEwen (1990), and further refined by Brockman

(2004), to examine the enforcement of complaints by the IDA for six years (2002-2007) leading up to the GFC. Brockman and McEwen (1990) and Brockman (2004) modified the crime funnel that was initially developed in order to show how the number of cases involving street crimes shrank as they were processed from arrest to sentencing through the criminal justice system (CJS), and applied it to examine the disposition of complaints by The Law Society of British Columbia. Brockman and McEwen’s model of case disposition by SROs is built on three fundamental concepts: “funnel in”, “funnel out” and “funnel away” (see Brockman and McEwen 1990; Brockman, 2004).

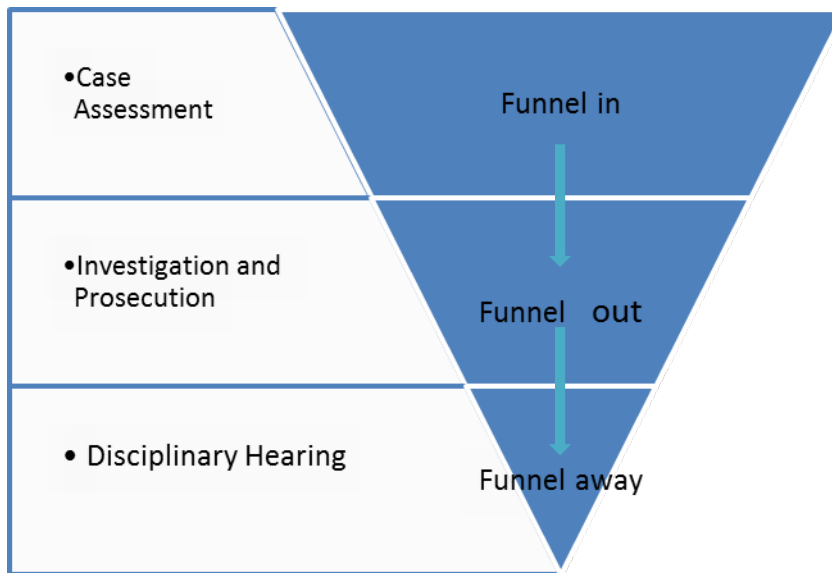


Figure 1: The SRO Misconduct Funnel

As can be seen in Fig. 1, “funnel in” tests the claim made by SROs, “that they enforce standards which would not otherwise be enforced” by other government agencies (Brockman and McEwen, 1990: 3). At the center of this premise is the notion that SROs scrutinize a wider variety of behaviours and ensure a higher standard than government regulators (p. 3). “‘Funnel out’ looks at how offenders might escape disciplinary action once they enter the system, and the

potential leniency of penalties imposed on those who are formally sanctioned” (Brockman, 2004: 73). The preoccupation of SROs to protect their own, “may function to keep their members from coming into contact with the CJS when criminal offences have been committed” (Brockman and McEwen, 1990: 4). This charge alleges that “SROs ‘funnel away’ individuals from the CJS who might otherwise come into contact with it” (p. 4). By applying the concept of the regulatory “funnel” to the context of professional self-regulation, this study will examine the enforcement practices of the IDA from 2002 to 2007.

It seems rather obvious that SROs will track more complaints than coercive state led enforcement (see Brockman & McEwen, 1998; Brockman, 2004). The resultant effect is that SROs are more likely to “funnel in” more complaints than would have been handled by the CJS. The “funnel in” argument is simply not compelling enough to justify the call for industry self-regulation (McCaffrey & Hart, 1998; Brockman, 2004). Perhaps of more importance, is the “funnel out” and “funnel away” concepts, where cases were dealt with in a manner that resulted in a laxity of sanctions imposed and in a lack of effective regulation (Canadian Foundation for Advancement of Investor Rights (FAIR Canada), 2011; Lokanan, 2014). Given this outcome, the objective of this paper is to examine the role of self-regulation in the Canadian securities industry and in doing so, address the following questions: To what extent were complaints ‘funneled out’ of the IDA’s disciplinary system? Did the IDA ‘funneled away’ complaints with criminal elements from the CJS, which would have otherwise been dealt with as *Criminal Code* offences?

In answering these questions, the study simultaneously makes two significant contributions to the literature on securities regulation. First, the study examines the allegation that SROs’ inability to deal with the more serious securities fraud cases is symptomatic of a

much larger problem (Williams, 2012, 2013; Snider, 2009). It could very well be that the IDA and perhaps SROs that operate in the securities industry in general, are ineffective because they are not equipped and therefore unable to deal with the more serious cases, and thus, represents a much larger systemic industry problem. Therefore, a more meaningful contribution to the literature is to look at the findings within the larger context of securities regulation, to enable a firmer assessment of SROs' enforcement performance. Second, over the last decade, SROs that operate in the securities industry have faced some significant challenges. Central among these challenges is the inherent conflicts-of-interests between SROs' regulatory functions of their members and their market regulating duties (Dorn, 2011). The present study will take a closer look at this relationship to show how one SRO – the IDA uses symbolic management to create a carefully crafted appearance of effective enforcement, despite empirical evidence showing its inability to effectively police the market in practice.

Having briefly surveyed the contextual problems associated with SROs and securities regulation, the remainder of the paper proceeds according to the following format. First, I provide a brief overview on SROs and the wider context of securities regulation in Canada. I then sketch the theoretical underpinnings and examine the arguments that have been used to justify the use of self-regulation and the criticisms leveled against its usage. This is followed by a brief description of the methodology employed to gather the data, and a discussion to address some of the limitations related to the data. I then examine the types of complaints received by the IDA and how these complaints were processed through the regulatory funnel from initial screening through to final disposition of the IDA's disciplinary system. Finally, I discuss the findings within the wider context of securities regulation and highlight areas for future research.

2. SROs and the Wider Context of Securities Regulation in Canada

One hallmark of Canada's securities regulatory landscape is the sheer number of different agencies with stakes in the regulatory game. The motley crew of agencies responsible for the governance of the securities markets, demands a brief review of their relationship. The agencies range from the SROs, to the provincial securities commissions, and the Royal Canadian Mounted Police (RCMP), all of which have their own legislations and enforcement frameworks that govern securities regulation. The commissions have their own *Securities Acts*; the SROs their Sanction Guidelines; and the RCMP the Canadian *Criminal Code*. The enforcement of these legislations is effected through administrative hearings, securities law quasi-criminal prosecutions, and criminal prosecution.

The enforcement of the provincial securities legislations and SROs' Guidelines are effected through administrative proceedings. The commissions can also effect quasi-criminal prosecutions under provincial securities laws in provincial courts. Quasi-criminal offences are punitive proceedings and are brought under the provincial securities act or SROs' Guidelines rather than the Canadian *Criminal Code*. Cases referred to the RCMP by the commissions and SROs or cases the RCMP initiated, are prosecuted under the Canadian *Criminal Code*.

3. Self-Regulatory Theoretical Framework

3.1. Self-regulation: The Concept

SROs come in many forms (Gunningham and Rees: 1997: 364). As such, there is no single overarching definition that guides their practices (Sinclair, 1997: 533-534). Rather, in order to appreciate the various dimensions of self-regulation, it is important to look at the context in which they operate. Depending on the context, a number of important definitions have been put forward. In its purest form, "self-regulation refers to situations in which firms, individuals, or

other parties are allowed to monitor and adjust their behaviour using certain standards and perhaps to set the standards themselves” (McCaffrey and Hart, 1998: 6). The implication of this definition is that industry self-regulation requires firms in the industry to decide to cooperate with each other (Gunningham and Rees: 1997: 365). These SROs are not “state-backed in the formal sense; the government neither legislates them into existence nor delegates powers to them” (Brockman and McEwen 1990: 2). Even though “the government might facilitate their formation through legislation governing associations and corporations, it is not usually involved in enforcing rules created by the SROs” (p.2). Examples of these are the early stock market exchanges, “where members participate in the group and adhere to written standards that govern the treatment of the group’s pooled resources” (p.9).

A more attenuated definition notes that “self-regulatory organization means [an entity] that is organized for the purpose of regulating the operations and the standards of practice and business conduct, in capital markets, of its members and their representatives with a view to promoting the protection of investors and the public interest” (Hockin Panel, 2009: 25). Central to this definition is the notion that consumer protection is paramount to a self-regulatory framework (Gunningham and Rees: 1997: 365). Membership in these SROs confers status and gives the registered members a competitive advantage over non-members. Lack of membership however, “does not affect their ability to work in that market sector” (CFA, 2007:10). In Canada, provincial law gives a professional association for each accounting designations the power to govern the profession in that jurisdiction. An example of such an association is the Chartered Professional Accountants of British Columbia (CPABC). The CPABC has its own education requirements and standardized examinations that members are expected to complete in order to

be licensed as Chartered Accountants (CA) in British Columbia. Once licensed, a CA has “Title Protection” and can expect to earn more than an accountant who is not licensed and accredited.

Less synonymous with the other definitions presented so far, is one that highlights state intervention into the regulatory affairs of SROs (Black, 1996; Rees, 1998). Here, self-regulation is defined as “a system that encourages (‘regulates’) certain social behaviours by a collective (the ‘Self’) in order to avoid direct state intervention (‘regulation’)” (CFA, 2007: 1). They are backed by the state, in that they are “created by legislation” and “delegated the power to make rules, investigate and adjudicate alleged breaches, and impose penalties on wayward members” (Brockman and McEwen 1990: 3). These SROs are usually established by professional groups, such as doctors and lawyers. An example of such an SRO is the Law Society of British Columbia. The Society has its own membership and licensing requirements for lawyers and articling students who wish to practice law in the province. Through the Legal Profession Act, there are provisions that govern the complaints and disciplinary processes of members accused of misconduct. The one distinguishing feature that sets these SROs apart from those that are classified as accredited associations with compulsory standards, is that individuals cannot offer specified services without being licensed by the regulatory body that oversees their profession.

For others, self-regulation has evolved to refer to government or government agencies that oversee the regulatory activities of SROs. From this position, self-regulation is presented to mean

the delegation of government regulatory functions to a quasi-public body that is officially expected to prevent or reduce both incompetence (lack of knowledge or ability) and misconduct (criminal, quasi-criminal, or unethical behaviour) by controlling the quality of service to the public, through regulating or governing a number of areas (Brockman, 1998: 588).

Even though an SRO in this category has the power to regulate themselves, the “government retains ultimate oversight authority in which it can override the group’s regulatory proposals or impose rules and regulations as it deem[s] warranted” (CFA, 2007: 10-11; also see Brockman 1998: 591). The Financial Industry Regulatory Authority (FINRA) in the U.S. falls into this category. The SEC oversees the regulatory activities of FINRA, but allows it to “generate rules and policies for broker-dealers and trading markets” (Pan, 2009: 17-18, 39). In Canada, the provincial securities commissions acted as the oversight committees for the SROs, which in turn oversaw the market regulation of exchanges, Member firms and investment and brokerage dealers. It is this form of self-regulation that is the principal focus of the present study.

Based on the forgoing discussion, it is evident that there is no clear definition of what constitutes self-regulation. What is evident however is that “there is a continuum, with pure forms of self-regulation and government regulation at opposite ends” (Gunningham and Rees: 1997: 366). The underlying variable is the SRO’s relationship with the state, which starts from voluntary self-regulation and involves no formal supervision to the degree of government oversight exhibited over the SRO at the highly regulated end of the continuum. However, these pure forms of self-regulation rarely exist. Instead, it may be more “helpful to think in terms of typologies of social control, ranging from detailed government command and control regulation to ‘pure’ self-regulation, with different points on the continuum encapsulating various kinds of co-regulation” (p. 366).

3.2. Self-regulation and The SRO’s Misconduct Funnel: Strengths and Weaknesses

The SRO’s misconduct funnel incorporates both the benefits and criticisms of self-regulation (Brockman, 2004: 55). Among the benefits of SROs, is that they claim to “‘funnel in’ more deviant behaviour than government regulators” would at a reduced cost. Central to this

claim is that SROs “enforce standards which would not otherwise be enforced” by other government agencies (Brockman and McEwen, 1990: 3). Standard setting and the detection of breaches of those standards should be the responsibility of those who are closest to the market (Gunningham and Rees, 1997: 366; Williams, 2012: 64). By virtue of their close proximity to the markets, the SROs are in a position where they are able to “scrutinize a wider variety of behaviours and thereby ensure a higher standard of conduct than if the public had to rely on government regulation” (Brockman and McEwen, 1990: 3). In many ways then, “funnel in” would subject more “deviant behaviour for observation, investigation and sanctions which would not otherwise be the subject of such careful review” under centralized government regulation (p. 3).

Certainly, self-regulation is not without its criticisms. Chief among these is that SROs are often seen as “being too lenient on their members and, rather than widening the net of social control as they claim, they are accused of “funneling out” so many complaints that they are ineffective in controlling wayward professionals” (Brockman, 2004: 55-56). Even though the standards are enforced, “enforcement is seen as ineffective and punishment as secret and mild” (Gunningham and Rees, 1997: 370). Self-regulation then is nothing more than a governance mechanism that “attempt[s] to deceive the public into believing in the responsibility of an irresponsible industry” and “a strategy to give the government an excuse for not doing its job” (Braithwaite 1993: 91). The recognized by-product of this regulatory conservatism is that the “members of SROs, and not the public, are viewed as being the beneficiaries of self-regulation” (Brockman and McEwen, 1990: 4).

Perhaps a more serious criticism of SROs is that their disciplinary system may keep their members from coming into contact with the CJS (Brockman, 2004: 57). This charge alleges that

“self-regulating professions take legitimate complaints of crime and have them ‘funneled away’ from the CJS” by dealing with them through their own disciplinary system (Brockman, 2004: 57). In the world of market and finance, criminal enforcement of financial intermediaries and their employees is seen as bad publicity and is not something that is encouraged by the SROs (Williams, 2012: 61).

4. Methodology

4.1. Data source one

Data from the IDA’s Annual Reports were used to examine the funnel metaphor from 2002 to 2007. The data were used to examine how investigation and prosecution staff processed complaints from initial reporting to the Case Assessment Group, to final disposition. Data were collected on case assessments, investigation and prosecution outcomes of complaints. Data comparing the penalties of cases that were sent to a formal disciplinary hearing for both Member firms and individual registrants were also gathered for further analysis.

4.2. Data Source two

Data from the annual enforcement reports only allowed to examine the “funnel in” and “funnel out” aspects of the SRO’s misconduct funnel. The “funnel away” aspect of the misconduct funnel was examined through the IDA’s tribunal cases retrieved from *Quicklaw*. In total, 292 cases were retrieved and coded for quasi-criminal offences between 2002 and 2007. The quasi-criminal offences that were coded were fraud, forgery, false endorsement, misappropriation of funds, and securities act breach. These offences were classified as quasi-criminal offences in the IDA’s Sanction Guidelines (see IDA, 2006: 2-3).

4.3. Limitations of the Study

There are two limitations to the present study that need to be addressed. First, the analysis of this study is only informed with data gathered from the IDA's enforcement annual reports and cases between 2002 and 2007. This is because the IDA's enforcement annual reports are not available for the years preceding 2002. Furthermore, I am unable to extend the analysis to the five years of enforcement data now available for IIROC. While IIROC's enforcement reports provide a high level overview of IIROC's enforcement performance since its inception, it is not detailed enough to allow for rigorous quantitative comparison to be made with the IDA's data.

Second, a number of issues have been raised with respect to the accuracy of ComSet data.² Of paramount importance is the tendency on the part of the firms to under-report problems or misdeeds that may have come to light (Williams, 2012: 117). Firms may disabuse clients of the validity of their complaints and encourage them either not to file a complaint or settle the matter in-house. There may also be firms who are predisposed to game the system by distinguishing between service and non-service related complaints. Service related complaints are not reported. Since the IDA has never given a definition of what constitutes service related complaints, firms may deal with the complaints internally and chose not to report them to ComSet. (p. 117).

In light of these limitations, some may be predisposed to argue that the aforementioned limitations may limit the credibility of the results. In this respect, it is important to pause and ask whether self-reporting by Dealer Members will uncover more systemic violations, and consequently make any significant impact on the results. As you will soon see, no information power is lost, because the results from the data available provide sufficient information for a

representative analysis. It is therefore highly unlikely that there would have been any significant changes in the results with additional ComSet data.

4.4. The IDA Enforcement Process

The IDA's Disciplinary Sanction Guidelines list the offences for which the Association can discipline its registrants and Member firms (see IDA, 2006). The Enforcement Department of the IDA, "is responsible for investigating allegations of regulatory breaches by [the] IDA Member firms and their registered employees, and when appropriate, prosecuting registered employees and firms in an IDA administrative hearing" (IDA, 2008: 2). There are three types of IDA administrative hearings: Contested, Settlement, and Expedited. The range of disciplinary sanctions is set out in sections 20.33 and 20.34 of the IDA's By-Laws and may include one or any combination of the following:

- (i) a reprimand;
- (ii) a fine up to \$1,000,000 for Approved Persons and \$5,000,000 for Members per offence or an amount equal to three times the pecuniary benefit obtained as a result of any contravention, whichever is greater;
- (iii) suspension of a Member's rights and privileges or of an Approved Person's approval to act as a partner, director, officer or employee of a Member, possibly on terms;
- (iv) termination of a Member's membership and the accompanying rights and privileges or revocation of an Approved Person's approval;
- (v) expulsion of a Member from the Association or prohibition of an Approved Person's approval for any period of time; and
- (vi) imposition of terms and conditions on a Member or conditions on a subsequent approval or continued approval of an Approved Person, as the Hearing Panel considers appropriate in the circumstances (IDA, 2006:4).

The IDA's enforcement process consists of three stages: case assessment (of complaints), investigations, and prosecution by enforcement counsel.

5. Findings

5.1. The Funnel Process: Funnel in

As mentioned earlier, SROs claim to “funnel in” more cases than the CJS would consider taking in (Brockman and McEwen, 1990: 13). In this section, I will look at the number of events reported to ComSet and complaints processed by the IDA’s Case Assessment Group.

5.1.1. Events Reported to ComSet

Table 1-1 Subject Nature of ComSet Events Reported

Type of Events Reported	2003		2004		2005		2006		2007	
	Count	Percent	Count	Percent	Count	Percent	Count	Percent	Count	Percent
Unsuitable Investment	1249	46.8	776	40.9	732	39.8	779	40.3	734	39.3
Unauthorized and Discretionary Trading	338	12.7	231	12.2	313	17	226	11.7	203	10.9
Misrepresentation	120	4.5	79	4.2	92	5	94	4.9	0	0
Disputed fees, commissions, and charges									130	7
Transfer of Accounts	36	1.4	38	2	32	1.7	79	4.1	76	4.1
Others	927	34.7	772	40.7	672	36.5	754	39	727	38.9
Total	2670	100	1896	100	1841	100	1932	100	1870	100

Table 1-1 indicates that Unsuitable Investments was the events most reported to ComSet. Regulators use suitability complaints to pursue what they consider to be more systematic misconduct. According to one IDA regulator,

suitability is the number one complaint that comes from clients and we use those as pathfinders. Where we identify that a suitability case is in fact valid, we might look further

into the broker's portfolios to see if this is just this particular client that got put into a particular type of equity, or is it more widespread across all of his clients (IDA #5, 9, as cited in Williams, 2012: 113).

Suitability complaints are also used to assess more ostensibly and serious forms of misconduct by senior officers in the dealer firm. Consider what this IDA regulator had to say about one complaint.

We had one example [where] the initial complaint was about suitability. We looked at the broker, and yes it was unsuitable. We looked across his portfolio and yes, he had all his clients in this particular equity. We looked more broadly. It was the branch manager that was actually getting a secret commission to park stock, and he was the one who was encouraging all of his brokers to put the stock in their clients' portfolios. So we went from a suitability, to a secret commission, to basically a market manipulation offence (IDA #5, as cited in Williams, 2012:113).

5.1.2. Case Assessment

The "Case Assessment Group is responsible for receiving cases from the public, ComSet and other regulators" (IDA, 2008: 9). At the Case Assessment stage, the IDA's staff will consider each matter to determine if there is sufficient evidence of a breach of the IDA's rules that warrants further disciplinary action. Only cases with sufficient evidence and in the IDA's jurisdiction will be sent to the Investigation team. With the remaining cases, the IDA may pursue a range of actions ranging from issuing a warning letter to the Member firm or individual registrant or refer the case to other regulatory agencies (including the securities commissions) and the police (see IDA, 2008: 9).

Table 1-2 Types and Percentage of Complaints (by Issue) Opened by the Case Assessment Group from January 01 – December 31

Complaints of File Open by Issue	2002		2003		2004		2005		2006		2007	
	N	%	N	%	N	%	N	%	N	%	N	%
Adequacy of books and records	16	1.5	9	0.6	6	0.5	4	0.3	5	0.4	6	0.5
Capital deficiency	13	1.2	12	0.8	4	0.3	6	0.5	5	0.4	3	0.3
Churning and excessive trading	7	0.7	16	1.0	14	1.1	8	0.6	3	0.2	10	0.8
Client priority rule violation	3	0.3	1	0.1	3	0.2	1	0.1	2	0.2	7	0.6
Conflict of interest	10	0.9	24	1.5	11	0.8	9	0.7	12	0.9	26	2.1
Failure to comply with policy 8	0	0.0	5	0.3	4	0.3	9	0.7	9	0.7	5	0.4
Falsification/forger of documentation	17	1.6	25	1.6	15	1.1	23	1.8	22	1.7	22	1.8
Files with No Violation Assigned	1	0.1	0	0.0	2	0.2	4	0.3	2	0.2	4	0.3
Inaccurate information on registrant application	6	0.6	3	0.2	4	0.3	2	0.2	2	0.2	2	0.2
Inaccurate information on Termination Notice	2	0.2	2	0.1	0	0.0	2	0.2	2	0.2	1	0.1
Inappropriate personal financial dealings	19	1.8	47	3.0	26	2.0	15	1.2	14	1.1	32	2.6
Insider trading/self-dealing	7	0.7	11	0.7	12	0.9	9	0.7	9	0.7	11	0.9
Internal control violations	26	2.4	23	1.5	20	1.5	27	2.1	7	0.5	23	1.9
Manipulation & wash trading	17	1.6	25	1.6	19	1.5	28	2.2	13	1.0	17	1.4
Margin Issues	51	4.8	27	1.7	4	0.1	8	0.6	3	0.2	10	0.8

Complaints of File Open by Issue	2002		2003		2004		2005		2006		2007	
	N	%	N	%	N	%	N	%	N	%	N	%
Misappropriation of funds or securities	3	0.3	10	0.6	4	0.1	2	0.2	7	0.5	10	0.8
Misrepresentation	30	2.8	145	9.2	114	8.7	99	7.8	117	8.9	129	10.6
Money Laundering	1	0.1	2	0.1	2	0.2	2	0.2	3	0.2	0	0.0
Other	0	0.0	208	13.2	260	19.8	188	14.8	272	20.7	139	11.4
Poor performance	27	2.5	57	3.6	17	1.3	10	0.8	9	0.7	16	1.3
Principal/agent issues	0	0.0	0	0.0	2	0.2	0	0.0	0	0.0	0	0.0
Prospectus, exemptions and related matters	7	0.7	7	0.4	5	0.4	23	1.8	20	1.5	3	0.3
Service issues	101	9.4	90	5.7	121	9.2	111	8.7	63	4.8	119	9.8
Supervision	12	1.1	31	2.0	40	3.1	38	3.0	29	2.2	30	2.5
Theft or fraudulent activities	31	2.9	29	1.8	18	1.4	23	1.8	32	2.4	80	6.6
Trading outside jurisdiction	4	0.4	5	0.3	3	0.2	2	0.2	8	0.6	1	0.1
Transfer of accounts	40	3.7	30	1.9	27	2.1	27	2.1	32	2.4	32	2.6
Unauthorized or discretionary trading	119	11.1	420	26.7	311	23.7	322	25.3	325	24.7	301	24.7
Undetermined	99	9.2	21	1.3	38	2.9	44	3.5	50	3.8	35	2.9
Unsuitable investment	243	22.7	281	17.8	203	15.5	222	17.5	234	17.8	140	11.5
Uniform Termination Notice	145	13.5	2	0.1	0	0.0	0	0.0	0	0.0	0	0.0
Violation of Commissions' or other SROs' Orders	7	0.7	2	0.1	1	0.1	1	0.1	2	0.2	4	0.3
Violation of IDA's orders	9	0.8	5	0.3	1	0.1	2	0.2	2	0.2	2	0.2
Total	1073	100	1575	100	1311	100	1271	100	1315	100	1220	100

In total, there were 7,765 complaints “funneled in” by the Case Assessment Group between 2002 and 2007. That is an average of about 1, 294 complaints per year. The most common complaints opened by the Case Assessment Group over the six year period were complaints relating to improper sales practices, misrepresentation, and service related issues. As shown in Table 1-2, complaints related to unsuitable investments decreased by close to half from 2002 when there were 243 (22.7%), to only 140 (11.5%) in 2007. Even though complaints decreased, unsuitable investments were still among the top two complaints opened by the Case Assessment Group throughout the five year period. On the other hand, complaints related to unauthorized and discretionary trading increased by more than half from 119 (11.1%) in 2002, to 301 (24.7%) in 2007. Service related complaints such as the mishandling of cheques and other customer related issues, as well as complaints related to misrepresentation of facts to clients and/or Member firms, fluctuated throughout the six year period.

Table 1-3 shows the number of files opened and closed by the Case Assessment Group from 2002 to 2007. With the exception of 2007, the IDA was able to deal with and close more than 85% of the complaints opened by the Case Assessment Group during that period. By combining the number of complaints received from ComSet with those from the public and other regulatory agencies, the IDA is in a better position to “funnel in” and deal with more complaints. It is expected that the complaints with enough evidence for charges to be laid, will make their way down the disciplinary process and “[in] the long run...should actually increase consumer satisfaction and decrease the number of complaints” (see Brockman, 2004: 72).

Table 1-3 Total Files Opened and Closed by Case Assessment Group from 2002-2007

As at	Open at Jan 1	Received During Period	Total open files during period	Closed During Period	Open at End of Period
Dec 31 2002	134	1073	1207	1037 (85.9%)	170 (14.1%)
Dec 31 2003	170	1506	1676	1521 (90.8%)	155 (9.2%)
Dec 31 2004	155	1254	1409	1230 (87.3%)	179 (12.7%)
Dec 31 2005	199	1237	1436	1279 (89.1%)	157 (10.9%)
Dec 31 2006	183	1269	1452	1260 (86.8%)	192 (13.2%)
Dec 31 2007	196	1155	1351	1100 (81.4%)	251 (18.6%)

5.2. The Funnel Process: Funnel Out

Once the cases enter the system, there is the possibility that offenders may escape disciplinary actions by being “funneled out” and thus, “escap[ing] the net of social control” (Brockman, 2004: 73; Brockman & McEwen, 1990: 15). There is also the possibility that offenders may be given lenient penalties by the disciplinary committee (Brockman, 2004: 73). But before a complaint reaches the disciplinary committee, complaints must first go through two additional hurdles: investigation and prosecution stages (e.g., see Brockman, 2004: 73). At the investigation stage, the IDA’s investigative staff must establish that the case has sufficient evidence before it can be sent to Enforcement Counsel for prosecution (IIROC, 2008: 2).

5.2.1. Investigation

It can be argued that the “funneling out” of complaints started at the Case Assessment stage. As mentioned earlier, some complaints may not have been “within the jurisdiction of the

IDA,” or some may not have been “a regulatory issue [that] warrant[ed] further investigation” (IDA, 2008: 9). Complaints that fell into these categories were either closed or sent to the appropriate body (p.9). The cases that were determined to warrant further investigations by Case Assessment staff were then referred to the Investigation unit to begin a formal investigation. At the investigation stage, if the matters were outside the scope of the IDA, they were referred to the police, securities commission, or another regulatory agency (IDA, 2008: 12). Upon completion of the investigation, investigation staff would prepare a detailed investigation report with recommendations “that the matter be closed with no further action [being taken] due to lack of evidence; issue a cautionary letter; or refer the matter to Prosecution for possible formal disciplinary action” (p.12).

5.2.2. Investigation Summary

Table 1-4 Total Files Opened and Closed by Investigation Unit from 2002-2007³

As at	Open at Beginning of Period (Jan 1)	Received During Period	Total open files during period	Closed During Period	Open at End of Period
Dec 31 2002	182	138	320	214 (66.9%)	106 (33.1%)
Dec 31 2003	106	166	272	162 (59.6%)	110 (40.4%)
Dec 31 2004	112	129	241	156 (64.7%)	85 (35.3%)
Dec 31 2005	85	212	297	134 (45.1%)	163 (54.9%)
Dec 31 2006	163	154	317	188 (59.3%)	129 (40.7%)
Dec 31 2007	130	148	278	141 (50.7%)	137 (49.3%)

As shown in Table 1-4, the number of files closed by the investigation unit was rather inconsistent throughout the five year period. Of particular importance is 2002, where the number of files closed was at its highest, reaching a peak of 214 (66.9%) and then decreasing substantially to 141(50.7%) by 2007. The inconsistency shown above should not detract from the

fact that the number of cases continued to shrink as they were processed through the IDA's enforcement system. There are fundamental reasons for this shrinkage at the investigation stage. Chief among these is the "risk tariff" associated with successful prosecution and the attendant discretion and regulatory will to prosecute "high risk" cases.

One of the benefits of framing enforcement in terms of the misconduct funnel is that it sheds light on the tendencies that constrained the IDA's enforcement process. The first of these tendencies was the emergence of an enforcement culture that tended to be risk averse (Braithwaite, 2005, 2013). Perhaps motivated more by fear rather than commendation for pursuing cases where the rewards for successful prosecution were low and the punishment for failure were high (Gunningham, 1987: 89; Braithwaite, 2005: 173), exceedingly high standards were set for case viability, while carefully plotting their investigation according to the safest and more secure paths possible (Williams, 2012: 101). This sort of conservatism was a reflection of the type of cases that were being closed because of a lack of evidence for successful prosecution. Litigation staff may have been cognizant of the high standards needed to secure a prosecution and may have chosen to close a case for the fear of going to court and losing. This type of 'regulatory inertia' of afraid to lose mentality, suggests that the enforcement staff only pursued cases that they could win (p. 101). In deciding to prosecute 'high risk' cases, enforcement staff must toe the line carefully.

The sense of caution that accompanied the avoider mentality was manifested in the discretion to prosecute 'high risk' cases. Even when a case was egregious enough to warrant a full investigation, regulators and law enforcement tended to be very cautious in their approach. A former member of the enforcement staff recounted the following message when dealing with litigation staff:

I remember one time where I wanted to bring an insider trading case and he came up and tried to convince me that I shouldn't bring it because we could lose because of this and this. I basically said 'bring the case we're gonna win it. And the people pleaded guilty shortly after the charges were brought (Lawyer #22: 7, as cited in Williams, 2012: 101).

The 'tread carefully' message was also driven home by a Crown Attorney with experience in prosecuting securities fraud cases:

You tend to want to take a conservative approach to these things because the cost of getting it wrong is pretty high...your case could be thrown out unless you can find another way of proving it. You don't want to embark upon a three, four, five year investigation based on information obtained from the securities commissions as your cornerstone. So you want to be conservative (Crown #2:, as cited in Williams, 2010: 102).

Regulators' aversion to risk consequently resulted in them taking on cases where they were certain of a win. More important however, was that the preoccupation with risk posed by the legal process could have produced perverse effect (Hawkins, 2002: 404). One such effect was the skewing to the distribution of cases towards straightforward matters at the expense of the more 'high risk' cases that may have been more difficult to litigate and prosecute (p. 404).

When 'high risk' cases did come to the fore, the existing turf war between the IDA, the provincial securities commissions, and the police made it difficult to secure successful prosecutions. Given that all these regulators had stakes in the regulatory game, it was inevitable that they would try to protect their turf and only handle cases that belonged to them.

Consider the following excerpt from one of the IDA's interviewees:

The IDA does an investigation and you have a bunch of market participants that fall outside our jurisdiction and then at the end of the day we take disciplinary action against our broker, but the commission has no appetite to chase those guys. Then we go to our hearing, a natural question for one of the hearing panelists is 'what's happening over here?' 'Nothing.' 'Oh nothing. Well if nothing is happening over here then why is this so serious?' So you're not getting the total picture. (IDA #2: 5-6: as cited in Williams, 2012: 77).

The antecedent effect of this turf war was the balkanization of Canada's financial market, which saw regulators releasing rules that were contradictory in nature, making it difficult for market participants to be compliant with them. Overlapping jurisdiction had given rise to a governance structure where multiple versions of rules were created on the same issue and released by both SROs and centralized regulators, each with regulatory stakes in the market.

Together, these limiting effects were among the reasons why the nature of the complaints changed, as the cases moved from the Case Assessment Group to Investigations. As mentioned before, the top four complaints handled by the Case Assessment Group were unauthorized and discretionary trading, unsuitable investments, misrepresentation and service issues (see Table 1-2). As can be seen in Table 1-5 below, while unauthorized and discretionary trading and unsuitable investments remained in the top four, they were no longer the top two complaints dealt with by the Investigation staff throughout the six year period. Rather, the top two complaints for each year were a mixed bag comprised of unauthorized and discretionary trading and unsuitable investments, as well as issues related to supervision, inappropriate personal financial dealings and theft and fraudulent activities. Other complaints that made up the top four that were sent to investigation were forgery, manipulation and wash trading, and conflict of interest. Noticeably missing from the top four complaints were misrepresentation and service related complaints. Since service related complaints are not seen as regulatory issues by the IDA, it is expected that they would not make it through to the Investigation unit. Misrepresentation of facts to clients, on the other hand, is seen as a regulatory issue and constitutes one of the regulatory offences under the IDA's Sanction Guidelines (see IDA, 2006: 46). One can only speculate that complaints regarding misrepresentation were disposed of at the case assessment stage, either because there was not enough evidence to build a case or the matters were classified

as technical breaches with no harm to investors and closed with a cautionary letter (see IDA, 2008: 9).

Table 1-5 Top Four Issues Referred to Investigation from 2003-2007

Year	1	2	3	4
2003	Unsuitable Investments	Unauthorized and discretionary trading	Supervision	Falsification/ forgery
2004	Supervision	Inappropriate personal financial dealings	Unauthorized and discretionary trading	
2005	Supervision	Unsuitable investments	Unauthorized and discretionary trading	Manipulation and wash trading
2006	Supervision	Theft and fraudulent activities	Unsuitable investments	Unauthorized and discretionary trading
2007	Supervision	Unauthorized and discretionary trading	Conflict of Interest	Unsuitable investments

5.2.3. IDA Internal Prosecution

Files referred from Investigations were then reviewed by the IDA’s Enforcement Counsel. Once Enforcement staff determined that there had been a breach in the IDA’s rules that warranted a disciplinary action, they then prepared the matter for a formal hearing. Cases with insufficient evidence to meet the legal test to prove a case may have been closed with a warning letter; closed with no further action or referred back to investigation for further inquiries (IDA, 2008: 35-36).

5.2.4. Prosecution Summary

Table 1-6 Results of Cases that were Referred to Enforcement Counsel for Prosecution from 2002-2007

As at	Open at beginning of period (Jan. 1)	Received during period	Total files open	Closed During the Period				Total closed during period	Open at End of Period
				With No Action	With Action & Warning Letters	Stayed	Dismissal		
Dec 31 2002	209	86	295	41 13.9%	147 49.8%			188 63.7%	107 36.3%
Dec 31 2003	107	137	244	31 12.7%	90 36.9%			121 49.6%	123 50.4%
Dec 31 2004	121	88	209	17 8.1%	101 48.3%	2 1%	1 .5%	121 57.9%	88 42.1%
Dec 31 2005	87	71	158	14 8.9%	63 39.9%	5 3.2%	2 1.3%	84 53.2%	74 46.8%
Dec 31 2006	73	118	191	10 5.2%	69 36.1%	2 1%	1 .5%	82 42.9%	109 57.1%
Dec 31 2007⁴	106	70	176	12 6.8%	59 33.5%			71 40.3%	97 55.1%

Once a complaint reaches Prosecution, it faces further hurdles (see Brockman, 2004: 73).

At the Prosecution stage, the IDA Enforcement Counsel will consider the recommendations made by the Investigation unit and decide how to proceed with them. As shown in Table 1-6, Enforcement Counsel continued to “funnel out” investors’ complaints by closing a significant number of complaints at the Prosecution stage without further action. Enforcement Counsel was at its busiest in 2002, when they closed 188 (63.7%) of the cases. However, the number of complaints closed decreased significantly to 71 (40.3 %) in 2007. As was seen in the Case Assessment and Investigation stages, Enforcement Counsel continued with the trend to dispose of complaints informally.

Table 1-7 shows the types of complaints that were referred to Prosecution. While unsuitable investments were one of the top four complaints dealt with at both the Case

Assessment and Investigation stages, it was noticeably missing as one of the top four complaints that made their way to Prosecution. A few reasons have been put forth for this outcome. It is noted that unsuitable investments can be measured in shades of grey. In other words, there may not have been the necessary clear and cogent evidence that would have resulted in a hearing that was likely to be successful. The results were that the matters may have been resolved through informal resolution or closed with no action (Condon and Puri: 2006: 33). In other circumstances, the complaints can cover a wide range of related issues and may not have been related to suitability issues at all. These issues range from “poor advice, a poor or unsuitable product, or just a ‘complaint of convenience’ as the complainant did not know how else to describe the complaint” (Black, 2006: 43). In other scenarios, “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” (Condon and Puri: 2006: 33). There were also instances where the

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. 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 (p. 33).

All of the above are possible explanations as to why complaints related to unsuitable investments are disposed of before they reach the Prosecution stage of the IDA's enforcement process.

Table 1-7 Top Four Issues Referred to Prosecution from 2003-2007 by Hearing Panels

Year	1	2	3	4
2003	Unauthorized and discretionary trading	Supervision	Falsification/forgery	Capital deficiencies
2004	Unauthorized and discretionary trading	Supervision	Falsification/forgery	
2005	Supervision	Unauthorized and discretionary trading	Capital deficiency	Inappropriate personal financial dealings
2006	Supervision	Capital deficiencies	Falsification/forgery	Unauthorized and discretionary trading
2007	Theft and fraudulent activities	Supervision	Capital deficiency and Manipulation and wash trading	Unauthorized and discretionary trading

On the other hand, the most common types of disciplinary actions relate to brokers who conduct discretionary and/or unauthorized trades. Canadian securities law specifically prohibits investment brokers from exercising discretion in their clients' account. A broker must have specific orders from his or her client to buy a specific security at a specific point in time (Baines, 2012: para. 26). Brokers break this rule simply as a matter of convenience:

The broker has approval in principle from the client and, on that basis, he makes the trade. While that is still a breach, it is not as serious as unauthorized trading, where the broker doesn't have any agreement with the client at all (para. 27).

Warren Funt, IIROC's vice-president of Western Canada, identified some of the reasons why this might be the case:

The first is monetary: the broker simply wants the commissions. The second is 'just plain laziness.' The broker can't be bothered getting trained and registered as a portfolio manager, which would allow him to make trading decisions on behalf of his clients. The third reason is that some brokers really believe they are acting in the best interests of their

clients. Funt says that, even if their intent is good, they are taking a huge risk, because if something goes wrong, the client can come back at them (Baines, 2012: para. 29-32).

Irrespective of the broker's good intention, sales or purchases of securities without the client's prior knowledge, goes against the just and equitable principle of trade.

Managing the outcomes of these actions by the myriad of actors and agents involved in stock transactions is not always in black and white. Statutory regulations "have offered important supports for those individuals who seek to invest their money in the market" (Reichman, 1991: 284). As noted above, these cases can be hard to police because it is not always clear whether "someone is a victim of a fraud or a reckless investor" (Gray & McFarland, 2013: para. 6). In many ways then, market regulation can provide the context where at least theoretically, all investors can calculate the odds of investing in the market; but, as is evident from the discussion so far, regulation is not always compatible with investors' actions (Reichman, 1991: 284; Braithwaite, 2013: 2). With this in mind, I now proceed to examine the "funnel away" aspect of the SRO's misconduct funnel.

5.3. The Funnel Process: Funnel Away

Continuing on with the funnel metaphor, the "funnel away" aspect of the regulatory funnel is concerned with whether SROs deflect cases away from the CJS in order to protect its members (Brockman & McEwen, 1990: 27). Under this assertion, it is expected that the IDA may not refer cases involving fraud, misappropriation of funds, and forgery to the CJS for investigation. Given that some of the cases with evidence of criminality may be difficult to prove in the CJS, the IDA might be justified in dealing with them internally. That said, the purpose of the "funnel away" aspect of the IDA's enforcement process is to identify the types of cases with "evidence of criminal activity" that could have justifiably been referred to the CJS (see IIROC,

2008: 1). This is not to say that these individuals would have been necessarily convicted of a criminal offence if charged, but it may have helped to identify some of the types of misconduct that have “element[s] of criminal” activities attached to them (IDA, 2006: 12).

Table 1-8 Quasi-Criminal Cases Funneled Away by the IDA

Cases Funneled Away from 2002-2007				
		Type of Hearing		Total
		Settlement	Contested	
Quasi- Criminal Offences	Fraud	3	12	15
	Forgery	15	22	37
	False Endorsement	3	0	3
	Misappropriation of Funds	8	18	26
	Securities Act Breach	13	8	21
Total number of cases		28	29	57
Total percent of cases		49%	51%	100%

Table 1-8 shows the cases that were "funneled away" from the CJS by the IDA. From 2002-2007, there were 57 individual offender’s cases that dealt with quasi-criminal offences. Of these, 28 (49%) were disposed of via settlement agreements and 29 (51%) through contested hearings. The fact that close to half of the quasi-criminal cases was disposed of via settlement agreements is in itself an issue of concern. One would have thought that these cases would have been referred to the CJS or alternatively, because of the alleged seriousness of the offences, they would have at least been sent to a contested hearing to be heard by an IDA’s hearing panel. On the surface, it may seem as if the IDA does not have an adequate basis to decide how to deal with quasi-criminal cases. However, there may be other compelling reasons why the IDA might facilitate settlement agreements with respondents. As one IDA regulator pointed out, the evidentiary requirements might be difficult to establish in a hearing:

We may agree that the investor's been harmed. We may agree that something was wrong. But can we prove it? If we can't prove it, then we can't go to a hearing. Or, if we do go to a hearing and the panel is not convinced, then that's as far as we can go (IDA interviewee # 5, as cited in Williams, 2012: 133).

There are also other instances where high powered attorneys seek to obtain an advantage for their clients on procedural rather than substantive grounds. According to one senior regulator,

[a] big challenge for all of us has been the criminalization of securities law. In the old days when there were administrative proceedings you didn't get people hiring [high profile lawyers] to represent them. You do today because there's a lot at stake. And that tends to bring in a complexity in the process because they of course want to introduce procedural practice that exist in the criminal courts but aren't really supposed to apply in an administrative context (IDA interviewee # 6, as cited in Williams, 2012: 150).

Together, these processes have come to represent a significant drag on the disciplinary process and combined to explain the significant proportion of settlement agreements entered into with the respondents. That said, it is possible that some of these cases were dealt with as quasi-criminal offences by the provincial courts, but there was no indication in the cases examined that quasi-criminal prosecution was pursued by Crown counsel.

5.4. Imposition of Penalties

Table 1-9 Penalties Assessed on Individual Offenders by Hearing Panels

Individuals							
	2002	2003	2004	2005	2006	2007	Total
Fines	\$2,292,000	\$2,401,250	\$4,147,000	\$2,142,500	\$3,092,500	\$1,817,712	\$15,892,962
Costs	\$323,400	\$531,035	\$773,015	\$392,797	\$490,744	\$478,718	\$2,989,709
Disgorgement	\$34,740	\$312,996	\$573,881	\$653,862	\$507,055	\$133,669	\$2,216,203
Total Decisions	46	41	64	42	32	42	267
Warning Letters	76	27	19	8	22	8	160
Suspensions	10	2	7	11	14	15	59
Conditions	25	19	37	30	28	26	165
Permanent Bars	6	9	17	14	9	9	64

Table 1-9 shows the total decisions completed by the IDA's disciplinary committee for the period from 2002 to 2007. Judging from the number of cases completed, the IDA continued to informally process complaints before they reached a hearing panel. On average, only about 45 cases per year made their way to a disciplinary hearing between 2002 and 2007. This is a striking contrast to the number of complaints that were initially processed by the Case Assessment Group in Table 1-3 above.

Table 1-9 also shows the penalties imposed by the IDA's hearing panels from 2002-2007. With the exception of 2004 and 2006, when the total fines imposed were \$4,147,000 and \$3,092,500 respectively, the total fines imposed for the other years never exceeded \$2.5 million. In addition to fines, warning letters and terms and conditions were the most frequent penalties imposed, followed by permanent bans from the Association and a period of suspension from working in the industry. Of these, a permanent ban is considered to be the most severe (see IDA, 2006: 12). A permanent bar is usually reserved for cases where

the public itself has been abused; where it is clear that a respondent's conduct is indicative of a resistance to governance; the misconduct has an element of criminal or quasi-criminal activity; or there is reason to believe that the respondent could not be trusted to act in an honest and fair manner in all their dealings with the public, their clients, and the securities industry as a whole (IDA, 2006: 12).

While a permanent ban can be seen as a deterrent, and that the IDA succeeded in getting rid of the individual from the industry, only 64 (or roughly 6 permanent bans per year) were imposed over the six year period.

Table 1-10 Penalties Assessed on Member Firms

	Firms						
	2002	2003	2004	2005	2006	2007	Total
Fines	\$4,110,000	\$191,654	\$20,583,577	\$1,046,596	\$1,930,651	\$1,045,000	\$28,907,478
Costs	\$337,675	\$73,535	\$280,069	\$227,000	\$98,241	\$85,000	\$1,101,520
Disgorgement	0	0	\$20,978,577	\$506,596	0	0	\$ 21,485,173
Total Decisions	6	6	10	13	11	6	52
Permanent Suspensions ⁵	2	0	0	2	0	1	5
Terminations	2	1	0	0	3	0	6
Warning Letters	16	13	5	8	11	4	57

Table 1-10 shows the penalties imposed on Member firms. On average, there were roughly nine Member firms disciplined per year. The total fines levied on Member firms were at its highest in 2004, amounting to \$20,583,577. With the exception of 2002, the total fines imposed on Member firms did not exceed \$2 million dollars for any other year. Even though the number of Member firm cases heard in 2004 was one more than the average, the disparity in fines over the six year period is partly due to the number of firms that were fined for market-timing offences in that year, for which harsher fines were imposed. One possible reason for the linear relationship between total fines and disgorgement imposed for 2004 is that Member firms had to disgorge the commissions earned from the market-timing offences.

Of the non-monetary penalties, warning letters were the most frequent sanctions imposed. From 2002 to 2007, the IDA's hearing panels handed out 57 warning letters. On the other hand, only 5 firms received permanent suspensions and 6 were terminated. A termination or a permanent ban on a Member firm is a serious penalty and is usually reserved for the more serious transgressions. How can these findings be interpreted? Are we supposed to believe that only 6 firms were involved in cases that deserved termination notices? Given that a considerable number of the complaints opened by the Case Assessment Group had criminal or quasi-criminal

element to them, it is difficult to comprehend why only 6 firms were terminated. Or is it that the IDA will only go after its Members who violate rules that warrants insignificant penalties such as warning letters? Whatever the reason, there was a litany of scandals involving brokerage firms in Canada within the last 10 years, and the fact that only 6 of them were terminated between 2002 and 2007 indicates that the IDA is reluctant to get tough with Member firms.

6. Discussion and Conclusion

6.1. The Funnel Metaphor Revisited

This study looked at the enforcement of complaints by the IDA and utilized data from the IDA's Enforcement Annual Reports and tribunal cases. The data allowed me to employ the regulatory funnel to examine the processing of complaints from initial screening to final dispositions in the IDA's disciplinary system. The argument that SROs "funnel in" more complaints than the state could deal with cannot be ascertained because there is no basis upon which to compare this assertion. What is known, however, is that with the addition of ComSet, the IDA was able to better position itself to scrutinize a wider variety of complaints, than it would have done otherwise. In reviewing these complaints, the IDA achieved greater inspectorial depth because the Case Assessment Group was able to look at more infractions with the existence of ComSet. The fact that the IDA looked at complaints that the state would not be interested in, is likely proof that the IDA does "funnel in" more complaints. ComSet also allowed the IDA to streamline the reporting process and made it easier for Members to report complaints. The existence of another avenue for investors to report their complaints is therefore significant.

The "funneling out" of complaints at the Investigation and Prosecution stages implies that the IDA is ineffective in controlling wayward registrants. The criticism that SROs are too lenient

on their members and that they “funnel out” complaints from the system, was evident in the Investigation and Prosecution stages in the IDA’s enforcement process. The number of complaints opened shrank significantly as they made their way from Case Assessment through to Investigation and Prosecution. The disposition of cases at the Investigation and Prosecution stages only allows for written reprimands - a penalty that is nothing more than a regulatory wrist slap. As such, the claim made by SROs that they set and impose higher standards than state regulators, is not substantiated in the IDA’s case. The appearance of lenient enforcement sends the wrong message to investors and investment professionals, and implies that the Association does not take these matters seriously.

There is also support for the claim that SROs’ function to deflect complaints with criminal elements away from the CJS. As shown in this study, the findings from the cases that made their way to an IDA hearing illustrated that the IDA was likely deflecting complaints with criminal elements away from the CJS. Perhaps this is because the IDA was more interested in protecting its members, rather than fulfilling its legislative mandate to serve the public interest. This inherent conflict -of- interest raises questions on the effectiveness of SROs to be a part of the investors’ safety net in the securities industry (Dorn, 2011). Some scholars even expressed concerns over whether SROs are working for the benefit of their members or serving the public interest as they so often claim to be (Brockman, 2004; Condon, 2008). An SRO that is supposed to be in charge of safeguarding the investing public, but at the same time, deflects investors’ complaints away from the CJS, is tantamount to putting a fox to guard a henhouse.

6.2. Broader Contribution to the Existing Research Literature

In the beginning, I mentioned that the present study makes two significant contributions to the research literature on securities regulation. First, SROs' inability to deal with the more serious securities fraud cases is symptomatic of a larger industry wide problem – that is, they are not equipped and therefore unable to tackle these cases. Before excoriating the IDA for this handicap, it is important to pause and consider the fundamental reasons for this systematic failure. With respect to the question of referrals to the police, it is entirely possible that the IDA did refer these cases to the police (or referred very similar cases in the past) but was rebuffed. Indeed, there is evidence to suggest that the police in general and the Integrated Market Enforcement Team (IMET) in particular, are not at all interested in taking on smaller cases from the SROs and securities commissions (Snider, 2009; Williams, 2012) – exactly the kinds of cases that are ending up at the bottom of the IDA's misconduct funnel. As one securities fraud lawyer noted,

“one of the most common complaints directed by regulators towards IMET is their unwillingness to take on smaller files with clear criminal overtones: ‘IMET don't touch anything unless it involves multi-millions of dollars whereas the small frauds, they don't have time for’” (Lawyer #6: 7, as cited in Williams, 2012: 72).

With case flow depending on the strategic interest of IMET, the IDA may have very well come to the conclusion that the complaints, while containing criminal elements, were not egregious enough to justify sending them to IMET.

IMET's failure to look at cases with criminal overtones could be because of their lack of expertise to investigate and prosecute securities offences in general. In the blunt assessment of a senior securities lawyer:

Unless things have improved remarkably, and it sounds like they've gotten worse, in my day the RCMP couldn't do anything. They were police officers who had no sophisticated understanding of financial markets. I don't want the securities commission to investigate murder. I don't want the RCMP at the same time to investigate insider trading. Most of the RCMP that were involved had a long history as police officers with very limited knowledge of the market. They were often given six week courses or six month courses in accounting and law and expect them to become experts. It's a joke (Lawyer #22: 4: as cited in Williams, 2012: 90).

Meanwhile, IMET's officers struggle to find non-structural explanations for their failures:

'The mandate [was] set extremely high...' 'It is now interpreted as [meaning that] every file has to affect the economy. This is a very high bar' ... 'We're being held to account because timelines were announced.' ... 'We need to deliver fast on a few big cases' ... 'I think there should be ... a National Securities Act – that would make [stock market fraud] a federal statute. This would give the RCMP a mandate to enforce' (Interviewees responses to Snider, 2009: 190-191).

IMET's lax enforcement of *Criminal Code* violations means that the burden to investigate and prosecute these complaints falls on the securities regulators.

The implication so far in the analysis is that, were the IDA to refer more cases to IMET to investigate and prosecute, and assuming that IMET takes on these cases, it would lead to the IDA being a more effective regulator. However, this overlooks the specific nature and characteristics of these cases and their significance from a larger regulatory perspective. Specifically, it should not be surprising that the offenses that end up at the bottom of the misconduct funnel involve fraud, forgery, and misappropriation of funds, as these are the most egregious forms of misconduct and they have a negative impact not only on the client, but also and more importantly, on their employer and the markets (Barnes, 2011: 187-188). In addition, it is likely that most of these cases involve advisors at the margins of the industry who have received warnings in the past but continued to engage in misconduct. And yet, the fact that these are the most egregious cases does not mean that they are the most significant from a regulatory perspective (see Barnes, 2011: 181-185). Indeed, it is likely that the harm to investors associated

with these forms of fairly conventional criminal activities are dwarfed by the much larger problem of unsuitable investment advice as well as unauthorized and discretionary trading articulated earlier. These cases often involve legal ambiguities and grey areas that make them less suitable to formal disciplinary action. Following from this, the more accurate and meaningful conclusion would thus be that the IDA is ineffective because it is unable to handle these more serious and systemic industry problems, and not necessarily its failure to pass overtly criminal cases over to the police.

The second significant contribution to the literature has to do with the overarching point of tension between the SROs' mandate to protect its members, while at the same time bolster investors' confidence and market integrity through active enforcement. The need to strike the right balance between safe and competitively regulated markets and efficiency in financial transactions has long been recognized as a core feature of financial market regulation (see Reichman, 1991). But as the following reveals, it is a double-edged sword:

You have this very difficult balance between doing an active regulatory job, which means ferreting out the proverbial bad guy and making sure the public is protected from him, and at the same time not creating what may be construed as an unnecessary chill in the marketplace or in some way discouraging the investment of capital in [the] markets. So that's one of the conundrums that the [SROs] face and it's a difficult one. And that's why you'll see in some regimes there's no enforcement at all... (Former OSC #2: 4, as cited in Williams, 2012: 48).

To manage the appearance of active enforcement, many SROs have turned to symbolic management. Symbolic management was advanced by Manning (1997) in his work on police agencies and the response to their mandates. According to Manning, police forces present a well-crafted image of effective enforcement largely for the media and public consumption, notwithstanding their inability to enforce the law in practice (pp. 19-22). To make a statement of active enforcement, the police will go after a small time con-artist, with an active media audience

present to convey a powerful message of enforcement activity. This is all done despite the fact that the con-artist is usually a small player in the larger criminal network and will do very little to deter other criminals from circumventing the laws. The result is detachment between the symbolic face of the police and effective policing.

The notion of symbolic management is relevant to SROs' policing of the market, as they go about managing their enforcement mandate. In particular, symbolic management highlights the concerns of managing the public face of the agency, a phenomenon that is not far off from the minds of the SROs' enforcement staff (see Williams, 2012: 49). Evidence of symbolic management was captured in the IDA's statistics going back to the year 2000. There were approximately 57 disciplinary proceedings from the year 2000 to June of 2008, involving IDA's registered Member firms. Of these 5 (or about 9%) applied to the top five banks. How can one comprehend these numbers when about 90% to 95% of the financial transactions in Canada flow through the top five banks, while at the same time about 91% of the IDA's disciplinary actions did not involve these banks? Does this mean that the IDA was captured by the five banks (who were its sponsors), or that the banks were more honest than the small brokerage firms that formed the majority of the disciplinary proceedings? If the disciplinary actions were in the 90% range for banks, it would have indicated a direct correlation. On the contrary, what the numbers seemed to indicate was that the IDA rarely went after the big fish (i.e., top banks), and did go after the small brokerage firms to make a statement of active enforcement. Alternatively, it could very well be that the IDA was unable to discipline its top Dealer members because of inherent conflict-of-interest issues.

The IDA has responded to the impetus to manage its appearance of effective enforcement and ward off government intervention in a variety of ways. The obvious one is of course to build

a strong relationship with the media. A case in point is the interview conducted by *Vancouver Sun*'s columnist, David Baines with Funt in which notable successes were highlighted and new initiatives were discussed (see Baines, 2012). Perhaps more important are the commissioned and annual reports, which cast the SROs' enforcement activities in a favourable light and tout them as strong enforcer of market malfeasance. Senior management personnel then used these reports in major conferences to outline the threats currently facing the markets and the steps they have taken to counter those threats (Williams, 2012: 50; Jenah, 2013: 13). These speeches intended to cast the organization in a favourable light, masked the institutional problems faced by SROs to protect the integrity of the market and simultaneously regulate in the public interest.

6.3. Self-Regulation and Global Financial Regulation

The findings presented in this paper have implications for self-regulation in global finance. If one is to measure the effectiveness of self-regulation in Canadian finance by using the proportion of fines and non-monetary sanctions imposed on market participants as a yardstick of effective regulation, then it is evident that self-regulation is not working. The securities markets are changing rapidly and the increasing complexity of financial products and practices are having an effect on the SROs' ability to regulate in the public interest (CFA, 2013: 3). Part of this changing infrastructure relates to the advancement of technology, which has caused the securities markets to become more electronic (CFA, 2007: 3). The access to high-speed internet has transformed the availability of and nature of financial products sold in the markets. This coupled with the low-cost global transfer of complex financial instruments, has brought about changes that are straining the capacity of SROs to regulate these products in sophisticated and well-integrated securities markets (Williams, 2012, 2013).

One of the financial instruments that caused strain on self-regulation to regulate

effectively is asset-backed commercial papers (ABCPs). Indeed, Canada's ABCPs' crisis in the period leading up to the global financial meltdown, mirrored the practices in the U.S. sub-prime mortgage fiasco, the events surrounding the credit risks associated with Northern Rock in the U.K., and the collapse of the Royal Bank of Scotland – also in the UK. Regulators – both SROs and of the state -- wiped their hands of these issues, until it was too late. In Canada, the ABCPs were packaged as securities and sold off to investors by investment firms. In the U.S., the sale of sub-prime derivatives was blamed on a mixture of self-regulation and the dispersion of market regulation across various financial intermediaries. In the U.K., the high risk lending and the balkanization of the European market resulted in a sovereign debt crisis that sent shock waves in the Eurozone. All national oversight authorities, by allowing the sale of sub-prime assets globally, were clearly shirking. They all relied on self-regulation where the governance mechanisms were still reflective of older market structures, and have yet to build and staff their operations with the expertise needed to monitor complex financial instruments (CFA, 2007, 2013; Semmler & Young, 2010; Williams, 2013).

Canada's financial sector has long been subjected to a fragmented regime, in part due to the fractured relationship between the provincial securities regulators, the SROs, and the police (Bhattacharya, 2006). In countries such as the U.S. and the U.K., market participants' report to a central body as in the Securities and Exchange Commission (SEC) and the Financial Conduct Authority (FCA). In Canada however, financial firms such as brokerage houses, as well as dealer members who trade in the exempt markets and their employees, must report to the SROs and the provincial securities commissions, both of whom have overlapping jurisdictions over these market players (Williams, 2012). This overlap decreases the efficiency of Canadian regulators to police market participants, and opens the door for regulatory arbitrage. The lack of transparency

as to who bears the ultimate responsibility of regulatory oversight over market players is also experienced in the far East. Hong Kong for example, has a three tier system of financial market regulation where various regulatory bodies are responsible for translating policies into regulation, supervision of financial services business, and supervising the activities of their members. The development of these *ad hoc* regulatory agencies led commentators to characterize Hong Kong's financial system as "fragmented" (Pan, 2009: 48). Hong Kong's "confusing matrix of sectoral laws and agencies with many gaps and inconsistencies" was seen as not being readily suited to deal with the GFC (Arner, Hsu, & Da Roza, 2010: 45). Fractured and fragmented, these mazes of regulatory miasmas allow regulators to short change the public and conceal criminal code violations when they occurred. The fragmentation of financial regulation is a major stumbling block for investors' protection, and the U.K. and the U.S. (with their centralized model), should all be aware of this having been home to some of the major financial scandals in the recent past.

6.4. What's Next?

The results from this study should prompt researchers and regulators with greater access to resources and information to conduct further cross-disciplinary research on securities regulation. Cases such as "Enron, WorldCom and Vivendi Universal do not appear in neatly labeled packages—addressed to 'sociology', 'finance', or 'economics'. Rather, they are phenomenological misfits, requiring a radical conceptual reconfiguration in order to be adequately appropriated" (Tinker and Carter, 2003: 577). Future research on market regulation and their intermediaries should take stock of this complexity and encourage further dialogue between white-collar criminology, sociology, finance and accounting – disciplines that are critical to an integrated analysis of market governance. Such a study must be cognizant of the

tensions that arise from pursuing cross-disciplinary research and mine the possibilities that a significant body of knowledge may arise and reveal new insights to market regulation. As a starting point, researchers can join hands and engage in a cross-disciplinary study that will examine whether IIROC with its increased enforcement budget and new image, is holding market participants accountable to law and ethical standards. It may be that the personnel who were part of the IDA are still heavily involved with IIROC's operations. Does this new body with its independence and higher enforcement budgets make investors safer in Canada?

References

- Arner, D., B. Hsu, and A Da Roza. 2010. Financial Regulation in Hong Kong: Time for a Change. *Asian Journal of Comparative Law*, 5, 1: 1-47.
- Baines, D., 2012. Regulator keeps investment industry honest. Available at: <http://www.vancouversun.com/business/Baines+Regulator+keeps+investment+industry+honest/6896800/story.html>. (accessed 24 October, 2013).
- Barnes, P., 2011. Insider dealing and market abuse: The UK's record on enforcement. *Journal of Law, Crime and Justice* 39, 174-189.
- Bhattacharya, U., 2006. Enforcement and its Impact on Cost of Equity and Liquidity of the Market. Available at SSRN: <http://ssrn.com/abstract=952698>
- Black , J.1996., Constitutionalising Self-Regulation. *Modern Law Review* 59 (1), 24 – 55.
- Black, J. 2006. Involving consumers in securities regulation. Taskforce to Modernize Securities Regulation in Canada, London, UK. Available at: <http://www.lse.ac.uk/collections/law/staff%20publications%20full%20text/black/Involving%20Consumers%20in%20Securities%20Regulation%20-%20Taskforce%20report.pdf> (Retrieved 10 November, 2014).
- Braithwaite, J., 1993. Responsive Regulation in Australia. In *Regulation and Australia's Future*, ed. Peter Grabosky and John Braithwaite, 67-79. Canberra: Australian Institute of Criminology.
- Braithwaite, J., 1993. Responsive Regulation in Australia. In Grabosky, P., Braithwaite, J (EDS.), *Regulation and Australia's Future*. Australian Institute of Criminology, Canberra.
- Braithwaite, J., 2005. *Markets in vice, markets in virtue*. Oxford: Oxford University Press.
- Braithwaite, 2013,. Flipping markets to virtue with qui tam and restorative justice. *Accounting, Organization, and Society*, 38(6-7): 458-468.
- Brockman, J., 1998. Fortunate enough to Obtain and Keep the Title of Profession: Self-regulating Organizations and the Enforcement of Professional Monopolies *Canadian Public Administration* 41 (4), 587-621.
- Brockman, J., 2004. An Update on Self-Regulation in the Legal Profession (1989-2000): Funnel In and Funnel Out, *Canadian Journal of Law and Society* 19 (1), 55-84.
- Brockman, J., McEwen, C., 1990. Self-Regulation in the Legal Profession: Funnel In, Funnel Out, or Funnel Away? *Canadian Journal of Law and Society* 5,1-46.

- Canadian Foundation for Advancement of Investor Rights (FAIR Canada) (2011) A Report on a Decade of Financial Scandals. Available at: http://faircanada.ca/wp-content/uploads/2011/01/Financial-scandals-paper-SW-711-pm_Final-0222.pdf . (accessed 08 February 2010).
- Chartered Financial Analyst (CFA) Institute., 2007. Self-Regulation in today's Securities Market: Outdated System or System in Progress? Available at: <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2007.n7.4819> (accessed 13 October, 2013).
- Chartered Financial Analyst (CFA) Institute , 2013. Self-regulation in the Securities Markets: Transitions and New Possibilities. Available at: <http://www.cfapubs.org/doi/pdf/10.2469/ccb.v2013.n11.1> (accessed 02 October, 2014).
- Condon, M., 2008. Technologies of Risk? Regulating Online Investing in Canada, *Law & Policy* 26 (3-4), 411-437.
- Condon, M., Puri, P. 2006. The Role of Compliance in Securities Regulatory Enforcement. Paper Commissioned by the Task Force to Modernize Securities Legislation (TFMSL) in Canada. Available at: <http://www.tfmsl.ca/docs/v6%281%29%20condonpuri.pdf> (accessed 11 November, 2014).
- Credit Suisse.2012. , Self-regulation Blamed for Global Financial Crisis: Regulatory Experts. Available at https://www.credit-suisse.com/conferences/aic/2009/en/reporter/day2/day2_3.jsp (accessed 12 December, 2012).
- Dorn, N. 2011., Reconstructing 'conflict of interest' in financial markets: Private management, public challenges, future prospects. *International Journal of Law, Crime and Justice* 39, 161-173.
- Engobo E., Ako, R., Okonmah, R., Obokoh, L., 2009., Corporations, CSR and Self-Regulation: What Lessons from the Global Financial Crisis? *German Law Journal* 11(2), 230-259.
- Gray, J., McFarland, J. 2013. Crime without punishment: Canada's investment fraud problem. Available at: <http://www.theglobeandmail.com/report-on-business/crime-and-no-punishment-canadas-investment-fraud-problem/article13938792/?page=3> (accessed 20 October, 2014).
- Gunningham, N., (1997). Negotiated Non-Compliance: A Case Study of Regulatory Failure, *Law and Policy*, 9(1):69-95.
- Gunningham, N., Rees, J., 1997. Industry Self-Regulation: An Institutional Perspective *Law & Policy* 19(4), 363-414.

- Hawkins, K., 2002. *Law as a Last Resort: Prosecution Decision-Making in a Regulatory Agency*. Oxford: Oxford University Press.
- Hockin Panel (Thomas Hockin, Chair) (2009). *Draft Securities Act*. Available at: http://www.expertpanel.ca/eng/documents/CAC_SBS_2009-01-07.pdf (accessed 17 November, 2013).
- Investment Dealer Association. 2006. *Disciplinary Sanctions Guidelines*. Available at: <http://www.iroc.ca/English> (accessed 15 March, 2013).
- Investment Dealer Association., 2008. *Member Regulation Enforcement Annual Report 2007*. Available at: <http://docs.iroc.ca/DisplayDocument.aspx?DocumentID=7C72EE3E241C43779BF9D0B02563CABB&Language=en> (accessed 23 May, 2013).
- Investment Industry Regulatory Organization of Canada. 2008. *Guide for Subjects of an Investigation*. Available at: http://www.iroc.ca/English/Enforcement/Investigations/Documents/GuideSubjectsInvestigation_en.pdf (accessed 14 September, 2013).
- Jenah, S., 2013. *Regulating in Challenging Times*. Available at: http://www.iroc.ca/Documents/2013/0d00c680-fe33-4a11-8f2e-dc167b42719a_en.pdf.
- Labaton, S., 2008. *S.E.C. Concedes Oversight Flaws Fueled Collapse*. Available at: <http://www.nytimes.com/2008/09/27/business/27sec.html> (accessed 10 June, 2013).
- Lokanan, M. E. 2014. *The Investment Dealers Association of Canada's enforcement record: Are penalties grossly inadequate?* *Journal of Financial Regulation and Compliance*, 22(3):.235 – 251.
- Manning, P., 1997. *Police Work: The Social Organization of Policing*. Boston: MIT Press: Boston.
- McCaffrey, D., Hart, D.,1998. *Wall Street Polices Itself: How Securities Firms Manage the Legal Hazards of Competitive Pressures*. New York: Oxford University Press.
- Pan, Eric. 2009. *Structural Reform of Financial Regulation: The Case of Canada*. *Cardozo Legal Studies Research Paper No. 250*. Available at SSRN: <http://ssrn.com/abstract=1333385>
- Rees, J., 1988. *Reforming the Workplace: A Study of Self-Regulation in Occupational Safety*. Univ. of Pennsylvania Press, Philadelphia.
- Reichman, N.1991. *Regulating Risky Business: Dilemmas in Security Regulation*. *Law and Policy*, 13, 4: 263:95.
- Semmler, W., & Young, B. (2010). *Lost in Temptation of Risk: Financial Market Liberalization*,

Financial Market Meltdown and Regulatory Reforms. *Comparative European Politics*, 8, 327-353.

Sinclair, D., 1997. Self-Regulation versus Command and Control? Beyond False Dichotomies. *Law & Policy* 19(4), 529-559.

Snider, L., 2009. Accommodating Power: the 'Common Sense' of Regulators. *Social and Legal Studies* 18(2), 179-197.

Tinker, T., Chris C., 2003. Spectres of accounting: Contradictions or conflicts of interest. *Organization*, *Organization* 10 (3), 577-582.

Williams, J., 2012. *Policing the Markets: Inside the Black Box of Securities Enforcement*. London: Taylor & Francis Ltd.

Williams, J., 2013.. Regulatory technologies, risky subjects, and financial boundaries: Governing 'fraud' in the financial markets. *Accounting, Organization and Society* 38(6-7): 544-558.

¹ In 2008, the IDA (the SRO responsible for regulating investment and brokerage firms in Canada) and Market Regulation Services Inc. (“RS”- the SRO responsible for regulating the marketplace), merged to create the Investment Industry Regulatory Organization of Canada (IIROC).

² The IDA’s Complaints and Settlement Reporting System (ComSet) is a database maintained by IIROC that requires Member firms to report investors’ complaints and disciplinary actions taken against registrants.

³ In interpreting these findings, it is important to point out that some of the files that were closed in a particular year were in fact open in the previous year.

⁴ The number of cases stayed and/or dismissed for 2007 was not recorded in the IDA’s 2007 annual report. One can only assume that for various reasons, the IDA chooses not to record these because the number of cases left open at the end of 2007 should have been calculated as follows: $(176-71 = 105$ instead of 97).

⁵ A permanent suspension will end up in a termination or a winding up of the firm. Firms that wind up are voluntarily released from the membership - expulsions are non-voluntary.