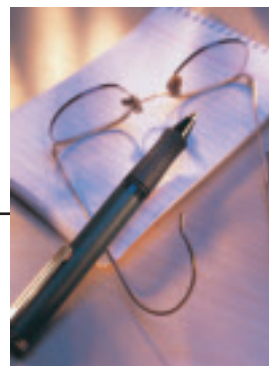


Will Canada step up?

Improving enforcement in the Canadian capital markets.

FIELD NOTES

BY POONAM PURI



In the wake of recent scandals in the Canadian capital markets, there has been a heightened awareness of the importance of securities regulation enforcement. In response to this, the Investment Dealers Association of Canada (IDA) commissioned the Task Force to Modernize Securities Legislation (Task Force) in Canada in June 2005. Chaired by Tom Allen, the Task Force released its final report in October 2006. Notably, a staggering 34 of the 65 recommendations made by the Task Force focused on the enforcement of Canadian securities laws, underscoring its priority for Task Force members and capital markets stakeholders.

An important point that caught the attention of the Task Force is the so-called “Canadian discount” in the cost of equity capital. One research study observed that the cost of equity capital is 25 basis points higher in Canada than in the United States, while another study concluded that Canadian public companies are valued significantly lower than those in the United States. There may be many explanations for this, including the fragmented structure of Canadian capital markets regulation and the perception (or reality) that Canadian securities law enforcement is less vigorous than in the U.S. It is clear that the removal of this Canadian discount plays an important role in improving Canadian economic growth.

CANADA AND THE U.S.

Strong enforcement of Canadian securities laws may enhance the credibility of Canadian capital markets, attract more risk-averse investors and increase valuations. Although there have been some U.S. successes in enforcement, the Task Force observed that this should not cause Canada to imitate U.S. enforcement approaches without

regard to the unique circumstances and characteristics of Canadian capital markets. There is a fairly respectable body of literature that suggests that transplantation of a legal system without regard to local culture and norms will likely fail. Thus, not only is a straight transplantation often not desirable, it may be impossible.

In order to more thoroughly understand the similarities and differences between Canadian and U.S. securities law enforcement, the Task Force commissioned a research study by Professor Howell Jackson of Harvard Law School that compared budget and staffing levels and data on enforcement activity. Surprisingly, when adjusted for population, GDP and other deflators, the levels of Canadian staffing and budget are very close to that of the U.S. In some cases, Canadian levels may be even more intensive. The study observed that Canadian regulatory budgets per staff member are lower than their counterparts in the U.S. The U.S. counterparts had regulatory budgets that were approximately 60% higher, suggesting that budgetary levels be reconsidered. However, increasing budgets does not necessarily imply that there would be an increase in number of enforcement personnel.

It was slightly more difficult to draw conclusions with respect to levels of enforcement activity. In part, this was due to many possible methods of comparison, such as the number of prosecutions, total monetary fines, levels of market capitalization. It was noted that, despite some fluctuations in Canadian enforcement activity in the past few years, there has been a general upward trend. It is not clear whether this upward trend is permanent or merely transitory and it was suggested that further research might be required.

One particularly important observation was that the

Poonam Puri is associate professor of Law, Osgoode Hall Law School, York University and visiting professor, Rotman School of Management, University of Toronto. She was also co-research director for the Task Force to Modernize Securities Regulation.

“It is not clear whether this upward trend in enforcement is permanent or merely transitory.”

FIELD NOTES

U.S. had a significantly higher level of private enforcement. Private enforcement refers to the ability of aggrieved investors to commence a lawsuit against parties who may have violated securities laws. This is different from public enforcement where it is a government official, typically a securities regulator, who commences a prosecution on behalf of the government. The research study cautioned against adopting a U.S. style of private class actions because there may be reasons to believe that this form of private lawsuit is not very efficient and may be inequitable.

SPECIFIC RECOMMENDATIONS

The Task Force also commissioned Justice Peter Cory and Professor Marilyn Pilkington of Osgoode Hall Law School to study the investigation, prosecution and adjudication of capital markets offences in Canada. The Task Force made a number of important recommendations, arising from their study, which included:

- **Specialized courts.** The creation of a separate and specialized capital markets court to hear securities laws cases was recommended.
- **National management of enforcement.** The Task Force recommended that a co-operative national program be established and funded by securities regulators, SROs and law enforcement agencies: (1) to establish priorities for enforcement, (2) to develop reporting systems that would provide a basis for assessing the effectiveness of enforcement processes in achieving their objectives, (3) to identify and collect any additional relevant data, and (4) to report the data and their qualitative analysis of it to an independent research body that will evaluate and issue public reports on the effectiveness of enforcement processes.
- **Evaluation of IMET.** The Task Force was particularly concerned about the Integrated Market Enforcement Teams (“IMET”), which was created in 2003 by the federal government with an annual budget of \$30 million to strengthen criminal law enforcement capabilities to detect, investigate and deter capital markets frauds and illegalities. The Task Force recommended that IMET continuously monitor and fulfill needs or expand police services to

cover needs unfulfilled by IMET. The Task Force also recommended that the position of a senior independent review officer be created in each jurisdiction in which there is a securities regulator and IMET presence to provide focus, supervision and accountability for strategic decisions in an investigation.

- **Clearer penalties and orders.** Lawmakers should consider enacting provisions similar to section 380 of the Criminal Code of Canada. These provisions would clearly indicate the type of aggravating factors that a court could take into account when imposing a sentence. On the flip side, it would also state the types of factors that should not play a part in reducing a sentence or fine. The Task Force envisioned that penalties and fines would be uniform across Canada but applied with regional sensitivity where circumstances dictate such an approach.

- **Restitution and remedies for aggrieved investors.** Securities regulators should consider making more frequent applications to the court, in addition to prosecuting offences, for compensation for aggrieved persons. One may also wish to consider empowering courts and tribunals to order compensation under a set of fair rules.

The Task Force also considered what Canada’s capital markets—and their regulation—would look like if its recommendations were adopted. In the context of enforcement, it would be commonly regarded as a serious mistake in judgment to contravene Canada’s securities laws, due to a focused and effective enforcement system, particularly if the recommendations were to invigorate the investigative, prosecutorial and adjudicative functions in the securities law enforcement system. As a result of implementing these recommendations, the “made in Canada” discount might become a “made in Canada” premium and the competitiveness of Canada’s markets would be markedly enhanced.

With the Task Force having met its mandate and goal, it is now up to capital markets stakeholders to propel Canadian regulators and legislators to take action so that this vision might be achieved. ■

A copy of the full study can be found at www.tfmsl.ca