Enforcement of Outcomes-Based Securities Legislation

New Legislation Project
British Columbia Securities Commission

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BCSC

A NEW WAY TO REGULATE

BRITISH COLUMBIA SECURITIES COMMISSION

About This Study

Parts of this study appeared in *Strong and Efficient Investor Protection: Dealers and Advisers under the BC Model – A Regulatory Impact Analysis*, published by the British Columbia Securities Commission in November 2003. It has been expanded to cover the enforcement implications of other aspects of proposed new British Columbia securities legislation. Other studies completed to analyze the impact of the new legislation are also posted on the BCSC website at www.bcsc.bc.ca/policy:

- *Better Disclosure, Lower Costs – A Cost-Benefit Analysis of the Continuous Market Access System* (October 2002)
- *Cost Savings Under a Firm-Only Registration System* (May 2004)
- *Investor Remedies in Securities Legislation – A Regulatory Impact Analysis* (May 2004)

About The New Legislation Project

The New Legislation Project was established by the British Columbia Securities Commission in October 2001 to modernize, streamline and simplify securities regulation in British Columbia. Its mandate was to prepare new securities legislation for introduction in the British Columbia Legislative Assembly during the Spring 2004 legislative session. The new *Securities Act* (Bill 38) was introduced on May 5, 2004.

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Executive Summary

This report summarizes a study conducted by the British Columbia Securities Commission on the enforceability of proposed new securities legislation. The study was part of a process begun in October 2001 to replace the current *Securities Act* with more modern and effective legislation. The new legislation (Bill 38 *Securities Act*) was introduced in the British Columbia Legislative Assembly on May 5, 2004.

One question asked by many of those who participated in the consultation process leading up to the introduction of Bill 38 was: "Can this new regime be enforced as effectively as the current legislation?" This paper contains the results of the analysis done by the BCSC to answer this question.

The new legislation

- The approach embodied in the new legislation leaves behind the over-use of detailed and prescriptive rules in favour of an outcomes-based approach, but it is founded on the same time-tested principles of investor protection as the current legislation: disclosure to investors and the regulation of dealers and advisers.

- However, the new legislation has a different look than the current law in British Columbia and other provinces because it is updated, simplified, and written in plain language. Perhaps it is these differences that have led some to ask how easily the new regime could be enforced.

The analysis

- We analyzed Commission decisions and settlements in 2002 and 2003 to determine the provisions most commonly relied on during that period to enforce the current legislation. We then compared those provisions to the corresponding provisions in the new legislation.

- We also analyzed how enforcement actions that relied on the Commission's general public interest jurisdiction could be handled under the new legislation.

- Finally, we analyzed the enforcement challenges presented by provisions in the new legislation that are not present in the current legislation.

The conclusions

- The most significant enforcement actions taken under the current legislation would continue to be supported by corresponding provisions in the new legislation. Of all contraventions, 92% were in areas in which the requirements under the new legislation are nearly identical, or substantially similar, to the current legislation, or have a similar "bright line" test.

- For some types of conduct (for example, conduct involving conflicts of interest), the new legislation would provide a more specific basis for enforcement action than the current legislation.

- Most of the new requirements in the new legislation would be readily enforceable because they would require measurable outcomes, use objective tests that are familiar to adjudicators, or deal with areas in which there is a rich understanding of what constitutes acceptable and non-acceptable conduct.

- The new requirements in the new legislation would be enforceable based on the development of industry standards, assisted by jurisprudence on the new rules.

We therefore think it is reasonable to conclude that the new legislation would provide a solid foundation to take enforcement action against market misconduct.

I. Background

On April 15, 2003, the British Columbia Securities Commission published the "BC Model" – draft legislation and rules that embodied the Commission's commitment to a new way of regulating securities markets. This was a major step in a process begun in October 2001 to replace the current *Securities Act* with more modern and effective legislation. The new *Securities Act* (Bill 38) was introduced in the British Columbia Legislative Assembly on May 5, 2004.

The BC Model was preceded by a concept paper (February 2002) and draft proposals (June 2002). Each phase involved extensive public consultations in British Columbia and across Canada. Through this process, the BCSC spoke with over 2,000 market participants and received 116 formal comment letters.

One question asked by many of those who participated in the consultation process was: "Can this new regime be enforced as effectively as the current legislation?"

The approach embodied in the new legislation leaves behind the over-use of detailed and prescriptive rules in favour of an outcomes-based approach, but it is founded on the same time-tested principles of investor protection as the current legislation: disclosure to investors and the regulation of dealers and advisers. Not surprisingly, the new legislation is therefore as capable of ready enforcement, if not more so, than the current legislation.

The new legislation, although an outcomes-based regime, still includes rules. For example, the draft Code of Conduct published as part of the BC Model, is a set of 28 rules organized under eight principles. As rules, they would have the force of law, and therefore be enforceable as legal obligations. Similarly, we expect the draft rules proposed for adoption under Bill 38 will include many rules relating to disclosure and filing requirements for issuers, dealers and advisers.

However, the new legislation has a different look than the current law in British Columbia and other provinces because it is updated, simplified, and written in plain language. Perhaps it is these differences that have led some to ask how easily the new regime could be enforced.

To help those who asked this question, we conducted the analysis described in this report.

II. Methodology

The analysis was to compare the effectiveness of enforcement under the new legislation with our actual enforcement experience under the current legislation. The analysis covered three areas:

First, we analyzed Commission decisions and settlements in 2002 and 2003 to determine the provisions most commonly relied on during that period to enforce the current legislation.[1] We then compared those provisions to the corresponding provisions in the new legislation.

Second, we analyzed how enforcement actions that relied on the Commission's general public interest jurisdiction could be handled under the new legislation.

Third, we analyzed the enforcement challenges presented by provisions in the new legislation that are not present in the current legislation.

[1] Our analysis of the Commission's enforcement action relating to registrant misconduct first appeared in our November 2003 paper entitled *Strong and Efficient Investor Protection Dealers and Advisers under the BC Model — A Regulatory Impact Analysis.* For that reason, decisions and settlements related to registrant misconduct after November 15, 2003 were not included in the study.

III. Findings

A. Most Common Contraventions

1. Misconduct by Registrants

Between January 1, 2002 and November 14, 2003, the Commission rendered two decisions and entered into 15 settlements relating to registrant misconduct. The 66 contraventions of the current legislation in those decisions and settlements are broken down as follows:

Know your client and suitability[2]	15
Fair dealing with clients[3]	13
Supervision[4]	9
Illegal distributions[5]	8
Prudent business practices[6]	7
Misrepresentation[7]	6
Other[8]	8

This distribution of contraventions is reason for confidence that enforcement under the new legislation would be no less effective than under the current legislation, for these reasons:

- 45 of the 66 contraventions (68%) in these cases were in the areas of know your client and suitability, fair dealing, prudent business practices, misrepresentation, and fraud.[9] In these areas, the language in the new legislation is substantially similar (sometimes nearly identical) to that used in the current legislation. It is therefore reasonable to conclude that the enforcement results under the new legislation in these areas will be the same.

- Another 11 of the 66 contraventions (17%) were in the areas of illegal distributions and trading and advising without registration.[10] The new legislation has

[2] Rules, section 48. See BC Model, Code, Principle 5.
[3] Rules, section 14. See BC Model, Code, Principle 1.
[4] Rules, section 47. See BC Model, Code, Principle 7.
[5] Act, section 61. See Bill 38, section 18.
[6] Rules, section 44. See BC Model, Code, Principles 1 and 2.
[7] Act, section 50. See Bill 38, section 28.
[8] Registration – 3 (Act, section 34; see Bill 38, section 14)
Information about registrant – 2 (Rules, section 50; see BC Model, Code, Principle 1)
Record keeping by registrant – 1 (Rules, section 27; see BC Model, Rules, sections 3D3, 10A1)
Safekeeping of client funds – 1 (Rules, section 58; see BC Model, Code, Principle 7)
Fraud – 1 (Act, sections 57, 57.1; see Bill 38, section 27)
[9] In many of the cases, there were multiple contraventions of one provision (contraventions of the same provision by multiple respondents or multiple contraventions of the same provision by the same respondent). These were only counted once. Had the multiple contraventions been counted separately, the results would have been even more heavily weighted in these areas.
[10] All of these cases involved registered dealers, but the registration requirements were still contravened. For example, one firm registered elsewhere in Canada, but not in British Columbia, was trading for and advising clients in British Columbia. Another dealer was permitting non-registered employees to engage in registrable activities.

corresponding prohibitions against trading or advising without being registered and against issuing securities without complying with a mandated disclosure regime. There would therefore be grounds for enforcement action under the new legislation against registrants (or others, for that matter) who trade or advise without being registered, or sell securities without following disclosure requirements.[11]

- The remaining 10 contraventions (15% of the 66) were in the areas of supervision, informing clients, record-keeping, and safekeeping of funds. In all of these areas, there are provisions in the new legislation that replace or correspond to the relevant provisions in the current legislation.[12] As discussed in Section C below, it is reasonable to believe that these new provisions will be as capable of ready enforcement as today's rules, and in some instances, more so.

2. Misconduct by Issuers, Management and Others

Between January 1, 2002 and December 31, 2003, the Commission rendered 10 decisions and entered into 22 settlements relating to the misconduct of reporting issuers, their management, and others[13]. The 65 contraventions of the current legislation in those decisions and settlements are broken down as follows:

Misrepresentations[14]	15
Illegal distributions[15]	11
Trading or advising without being registered[16]	11
Breaches of directors' duties[17]	8
Failure to file insider reports[18]	6
Fraud[19]	6
Market manipulation[20]	4
Insider trading[21]	2
Failure to disclose material change[22]	2

This distribution of contraventions is compelling evidence that enforcement under the new legislation will be no less effective than under the current legislation, because all of these provisions are duplicated in the new legislation:

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[11] See Bill 38, sections 14, 18.
[12] See BC Model, Code of Conduct, Principle 7, sections 1-3 (supervision); Code of Conduct, Principle 2, sections 1 and 2 (informing clients); Code of Conduct, Principle 2, section 3, and Rules, sections 3D3, 10A1 (record keeping); and Code of Conduct Principle 7, section 7 (safekeeping). The rules to be adopted under the new *Securities Act* have not yet been published for comment, so references to sections expected to be included in those rules are to the corresponding provisions in the BC Model as published April 15, 2003.
[13] In this section, we have included decisions and settlements involving individuals who are neither registrants, nor directly involved with any reporting issuer. We have not included either of the two decisions from this period that involve consideration of the take over bid provisions in the Act as the new legislation's take over bid rules will be identical to those in place today.
[14] Act, section 50. See Bill 38, section 28.
[15] Act, section 61. See Bill 38, section 18.
[16] Act, section 34. See Bill 38, section 14.
[17] BC *Company Act*, section 118 (now *Business Corporations Act*, section 142).
[18] Act, section 87. See Bill 38, sections 25, 26.
[19] Act, section 57, 57.1. See Bill 38, section 27.
[20] Act, section 57, 57.1. See Bill 38, section 27.
[21] Act, section 86. See Bill 38, section 30.
[22] Act, section 85. See Bill 38, sections 23, 24.

- 43 of the 65 contraventions (66%) in these cases were in the areas of misrepresentation, breach of directors' duties, failure to file required documents (insider reports and material change reports), fraud, market manipulation and insider trading.[23] The language in the new legislation in these areas is substantially similar or nearly identical to that used in the current legislation.

- The remaining 22 of the 65 contraventions (34%) were in the areas of illegal distributions and trading and advising without registration. See the discussion under *Misconduct by Registrants* on this subject.

In one of the 10 decisions in this period, the Commission did not rely on a contravention of a specific provision of the legislation.[24] In that case, the Commission made an order in the public interest based on its general power in section 161 of the Act. This aspect of current section 161 is continued in nearly identical language in section 59 of Bill 38.

3. Combined Results

Combining the results of the previous two sections:

- 67% of the total contraventions (88 of 131) were in areas where the language in the new legislation is substantially similar or nearly identical to that used in the current legislation.

- 25% of the total contraventions (33 of 131) were in the areas of illegal distributions and trading and advising without registration, which would be "bright line" contraventiuons under Bill 38.

- 8% of the total contraventions (10 of 131) were in areas where there are provisions in the new legislation that replace or correspond to the relevant provisions in the current legislation. See Section C below.

For the reasons set out above, we are confident that the Commission's ability to take enforcement action will be equally as, if not more, effective under the new legislation as it is today.

B. Public Interest Jurisdiction – *Re Cartaway*

Commission sanctions are not always based on contraventions of the Act and the Rules. In some cases, the Commission also makes orders based on its general power in section 161 of the Act to make orders in the public interest.[25] *Re Cartaway*[26] is instructive as an example of how conduct now handled in enforcement proceedings under the general public interest power could be handled under the new legislation.

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[23] In many of the cases, as in the registrant context, there were multiple contraventions of one provision, which were counted only once for the purpose of this analysis. See footnote 9.
[24] See *Re Boyle* 2003 BCSECCOM 852.
[25] This power is kept in the new legislation – see Bill 38, section 59.
[26] 2000 BCSECCOM 88. The Commission imposed sanctions in *Re Cartaway* 2001 BCSECCOM 594.

In *Cartaway*, the Commission found that the respondents contravened various sections of the Act and Rules. However, much of the conduct that contributed significantly to the sanctions imposed by the Commission was conduct that did not contravene any specific provisions of the Act or the Rules, but was found by the Commission to be contrary to the public interest.

1. Background

The respondents were among a group of eight brokers employed by a registered dealer and who bought control of Cartaway Resources Corporation, a shell company listed on the Alberta Stock Exchange.[27]

The brokers intended to change Cartaway's business direction and finance it through their dealer. To this end, the respondents acquired a group of Voisey's Bay claims for Cartaway through a nominee private company. At the time, the Voisey's Bay area of Labrador was experiencing a major staking rush as a result of a significant mineral discovery.

Meanwhile, Cartaway completed a brokered private placement 80% of which was bought by the eight brokers. As a result, they were in the money by a factor of three and owned over 70% of Cartaway on a fully diluted basis. Cartaway announced the private placement but did not disclose the acquisition of the Voisey's Bay claims.

A couple of months later, Cartaway closed another brokered private placement. The brokers' dealer was agent for the offering and all of it was placed with the dealer's clients. In announcing this financing, Cartaway disclosed the acquisition of the Voisey's Bay claims for the first time. It did not disclose the roles of the respondents in acquiring the claims, the extent of the shareholdings of the eight brokers, or any of the related conflicts of interest.

2. Commission findings

The Commission found that the respondents had contravened disclosure requirements, the prohibition against selling securities without filing a prospectus (the panel found that an exemption purportedly relied upon was not available), and the duty to act fairly, honestly and in good faith with their clients.

More germane to this discussion, the panel also found that the respondents had acted contrary to the public interest because they:

- put themselves in a position in which their interests were in conflict with their duties to their clients, and then acted in their own interests and not in the best interests of their clients

[27] A predecessor of the TSX Venture Exchange.

- failed in their duty to act as gatekeepers of the securities markets and not to engage in any conduct that would tend to bring the reputation of the securities markets into disrepute

- deceived and intentionally misled their dealer, its clients, the exchange and the public

- failed, as the de facto directors and officers of Cartaway, to act honestly, fairly and in the best interests of Cartaway

The current legislation contains no provisions that deal directly with this conduct.

3. *Cartaway* under the new legislation

We expect that the Rules to be adopted under the new *Securities Act* will include a Code of Conduct for registrants and related guidance similar to that published with the BC Model. The Code would deal directly with the types of misconduct that were found in *Cartaway*, as discussed in the paragraphs that follow.

Acting in conflict with the interests of clients
The Code would require registered firms and their representatives to resolve all conflicts of interest in favour of the client using fair, objective, and transparent criteria. It would also require disclosure to the client of any information that a reasonable client would consider important in the ability of the firm or its representatives to provide objective service or advice.[28] It is clear that the clients' interests must always come first. The guidance would highlight the risk of conflict that arises when representatives of registered firms act as directors of issuers. The conduct of the respondents in *Cartaway* would have been demonstrably in contravention of these provisions of the Code on the basis of the facts found by the panel.

Damaging the reputation of securities markets
The Code would require that registered firms and their representatives not engage in conduct that would bring the reputation of the securities market into disrepute.[29] The guidance would refer to the gatekeeper role. The conduct of the respondents in *Cartaway*, as found by the panel, would have contravened this section of the Code.

Deceptive and misleading conduct
The Code would require that registered firms and their representatives act honestly, fairly, in good faith and in the best interests of their clients.[30] The deceit and misleading statements found by the panel in *Cartaway* would clearly violate this provision, as well as the duty not to bring the reputation of the securities market into disrepute.

Failure to comply with duties as directors and officers
Corporate legislation imposes duties on directors and officers of corporations to act honestly and in good faith with a view to the best interests of the corporation, and to exercise the care, diligence and skill that a reasonably prudent person would exercise in

[28] See BC Model, Code, Principle 6, sections 1, 3.
[29] See BC Model, Code, Principle 1, section 4.
[30] See BC Model, Code, Principle 1, section 1.

comparable circumstances.[31] The conduct of the respondents in *Cartaway*, as found by the panel, would have contravened this provision.

These examples show how the Code would deal more clearly with conduct that the Commission found to be contrary to the public interest.

C. Enforcing New Requirements

In the previous sections we saw that the principles-based rules in the current legislation form the foundation for most enforcement action against registrants, and that these rules are carried forward in substantially similar form in the new legislation. We also saw that the new legislation provides a more specific basis to take enforcement action against some forms of conduct that is currently dealt with solely though the Commission's public interest jurisdiction.

This accounts for six[32] of the 43 rules in the Code and Divisions D and E of Part 3 of the Rules under the BC Model.[33] That leaves 37.

Many of the rules in the new legislation, including several provisions of the Code of Conduct, would express regulatory requirements in terms of observable outcomes – for example, requirements to segregate client assets or to create a "Chinese wall". Of the remaining 37 rules, 24 fall primarily into this category.[34] These requirements pose few enforcement challenges out of the ordinary – generally it will be clear on the evidence as to whether or not the respondent delivered the outcome mandated by the legislation. That leaves 13 of the 43.

Another nine rules[35] either contain objective legal tests, or deal with areas about which there is already a high level of understanding about what conduct is expected. An example of the former is section 1 of Principle 2 of the Code, which would impose the requirement to keep clients informed of all facts "that a reasonable person would consider important to the business relationship". Although this is not a bright line test, courts and tribunals are accustomed to dealing with standards expressed on the basis of reasonableness, and the evidentiary requirements necessary to establish compliance or non-compliance with those standards.

An example of the latter is section 3 of Principle 7 of the Code, which would impose the requirement to hire only suitable individuals and to supervise them. The important principles of supervision are well-understood by industry participants.

We therefore do not think that these requirements will pose significant enforcement challenges.

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[31] *Business Corporations Act (British Columbia)*, section 142.
[32] BC Model, Code: Principle 1, sections 1, 2, 4; Principle 5, sections 1-3.
[33] These Rules would regulate the ongoing conduct of dealers and advisers.
[34] BC Model, Rules: Part 3, Divisions D and E; Code: Principle 1, sections 3, 5, 6; Principles 3, 4; Principle 6, section 2; and Principle 7, sections 4, 5, 7.
[35] BC Model, Code: Principle 2, sections 1-3; Principle 6, sections 3, 4; Principle 7, sections 1, 2, 3, 6.

This leaves four rules: Code Principle 2, section 4 (plain language), two sections in Principle 6 (Conflict of Interest)[36] and Principle 8 (Client Complaints). All of these rules reflect broader regulatory principles and some are new in concept. For that reason, some uncertainty is to be expected after implementation of the new legislation until market participants, regulators and courts gain experience in interpreting and applying the new rules.

The rule likely to be of most interest from an enforcement perspective is section 1 of Principle 6 of the Code, which states:

> Resolve all significant conflicts of interest in favour of the client using fair, objective, and transparent criteria. If there is a conflict of interest between clients, use fair, objective and transparent criteria to resolve those conflicts. In both cases, apply the criteria consistently.

The concern of enforcement staff would be that what constitutes "fair, objective and transparent criteria" may well lie in the eye of the beholder and it could be difficult to prove a violation of this standard.

There is a risk that some might try to exploit this language by palming off an inadequate set of criteria as "good enough". However, the vast majority of the regulated community is compliance-minded and will use the period following implementation of the Code to develop criteria and policies that meet the spirit and intent of the Code. Through this mechanism, industry will develop a standard that is considered effective in delivering the outcome required by this rule.

Although not determinative, evidence of industry practice is a relevant benchmark in measuring impugned conduct. This is so today, and will be so under the new legislation.

The firm whose standards are significantly lower than those generally followed by its peers would have to justify the differences. This is especially so if the firm has systemic flaws that have either actually harmed clients, or have exposed them to significant risk of harm, which is likely to be alleged if the matter is being dealt with through enforcement proceedings.

We think it is reasonable to conclude that the development of standards by industry in response to the Code, and the continuing updating of guidance by the Commission in response to industry questions and concerns, will deliver a standard of certainty sufficient to deal with misconduct at the level at which enforcement proceedings are appropriate. Further certainty would emanate from Commission decisions in enforcement matters.

Firms that are intentionally non-compliant are on even riskier ground. The Code would force firms to take responsibility for compliance, and the intentional violator would be exposed to administrative sanction under a host of Code provisions.

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[36] Sections 1, 5.

IV. Conclusion

We have seen that:

- The most significant enforcement actions taken under the current legislation would continue to be supported by corresponding provisions in the new legislation.

- For some types of conduct (for example, conduct involving conflicts of interest), the new legislation would provide a more specific basis for enforcement action than the current legislation.

- Most of the new requirements in the new legislation would be readily enforceable because they would require measurable outcomes, use objective tests that are familiar to adjudicators, or deal with areas in which there is a rich understanding of what constitutes acceptable and non-acceptable conduct.

- The new requirements in the new legislation would be enforceable based on the development of industry standards, assisted by jurisprudence on the new rules.

We therefore think it is reasonable to conclude that the new legislation would provide a solid foundation to take enforcement action against market misconduct – as least as solid as today's, and more so in some important areas.