COR#04/029

Decision

Research Capital Corporation

Section 161 of the *Securities Act*, RSBC 1996, c. 418

Hearing

Panel	Douglas M. Hyndman Joan L. Brockman Robert J. Milbourne	Chair Commissioner Commissioner
Date of Hearing	November 27, 2003	
Date of Decision	February 27, 2003	

Appearing

Alan E. Keats	For Commission staff
H. Roderick Anderson	For Research Capital Corporation

Introduction

¶ 1 This is a hearing under section 161(1) of the *Securities Act*, RSBC 1996, c. 418. Commission staff is seeking the following orders in the public interest against the respondent Research Capital Corporation:

1. An order that Research Capital comply with or cease contravening the Act;
2. An order that Research Capital be reprimanded;
3. An order that Research Capital pay an administrative penalty;
4. An order that Research Capital pay the costs of the hearing; and
5. Any other orders that may be appropriate.

¶ 2 The Executive Director issued a notice of hearing on June 17, 2003. We held the hearing on November 27, 2003.

¶ 3 The notice of hearing alleges that Research Capital traded securities of Thermo Tech Technologies Inc. in contravention of a cease trading order that had been issued by commission staff.

¶ 4 Commission staff entered as evidence an agreed statement of facts and some other documents concerning the cease trading order and the trading. We also heard oral evidence about the investigation and the process for disseminating cease trading orders from commission staff member Mark Wang. Research Capital entered an affidavit from its compliance director in Toronto, Kevin McQuaid, but he did not attend the hearing.

Background

¶ 5 Research Capital is registered as an investment dealer in British Columbia and other provinces. Its head office is in Toronto and it has a branch in Vancouver.

¶ 6 Thermo Tech Technologies Inc. is incorporated under the Canada Business Corporations Act and is a reporting issuer under the Act. It is not a reporting issuer in any other jurisdiction.

¶ 7 Thermo Tech's shares were traded in the United States on the NASD Over-the-Counter Bulletin Board until December 5, 2001 when they were delisted, and currently the shares are quoted on the Pink Sheets Electronic Quotation Service. Thermo Tech shares are not traded or quoted on any Canadian exchange or market.

¶ 8 On July 14, 1999, commission staff issued a cease trade order under section 164 of the Act that all persons in British Columbia cease trading in the securities of Thermo Tech. The basis for the order, stated in the order itself, was that Thermo Tech had failed to make adequate disclosure about a material change, consisting of an acquisition of a business in a non-arm's length transaction.

¶ 9 The cease trade order was made public in the commission's Weekly Summary for the week ending July 16, 1999.

¶ 10 No other securities regulatory authority has issued a cease trade order against Thermo Tech. Since the order was issued, no exchange or market has halted or otherwise restricted trading in Thermo Tech shares, except when the OTC Bulletin Board delisted the shares on December 5, 2001.

¶ 11 On February 16, 2000, staff issued an order under section 171 of the Act varying the cease trade order to permit British Columbia residents and persons holding securities of Thermo Tech in British Columbia (except insiders, some others listed

in the order, and their associates) to sell any Thermo Tech securities that they acquired on or before July 14, 1999.

¶ 12 The variation order was made public in the commission's Weekly Summary for the week ending February 18, 2000.

¶ 13 At the time of both the cease trade order and the variation order, the Weekly Summary periodical was mailed in hard copy to subscribers. Research Capital was a subscriber.

¶ 14 In 2001, staff became aware that a number of brokerage houses, including some major national firms, had traded Thermo Tech shares in contravention of the orders.

¶ 15 On November 22, 2001, staff concluded a settlement agreement with 13 firms. The firms admitted that, as a result of deficiencies in their internal systems, they executed trades in contravention of the orders. Each of them undertook that, within 12 months, they would develop and implement a system or process to inform themselves of outstanding cease trade orders. The firms collectively agreed to pay the commission $26,000 for costs of the investigation and $350,000 to be used by the commission to assist in development of a database listing cease trade orders and an interface between that system and order management systems used by the firms. The settlement agreement was posted on the commission's web site on December 6, 2001.

¶ 16 On January 21, 2002, staff concluded a second settlement agreement with another 4 firms. They paid $8,000 in costs and $14,000 to be used for the database. The settlement agreement was posted on the commission's web site on February 7, 2002.

¶ 17 Neither of these two settlement agreements indicated the number of trades or the number of shares traded in contravention of the orders. On the motion of Research Capital, we rejected commission staff's attempt to enter evidence of this information, on the basis that we should not look behind the settlement agreements.

¶ 18 On April 9, 2002, staff concluded a third settlement agreement with one firm. It purchased 22,000 Thermo Tech shares and sold 20,000, in three transactions over two days. It agreed to pay the commission $1,500, including $500 for costs.

¶ 19 Staff of the Canadian Venture Exchange, as it then was, conducted a trade desk review of Research Capital and identified some trades in Thermo Tech shares. They notified commission staff on February 8, 2002.

¶ 20 Research Capital provided staff with trading blotters and account statements for persons who traded in Thermo Tech shares from July 14, 1999, when the cease trade order was issued, to February 21, 2002, when staff began the investigation. Staff analyzed the records to identify trades involving clients or Research Capital representatives in British Columbia. The analysis revealed that, during the period from February 14, 2000, to February 21, 2002, Research Capital contravened the orders by purchasing 96 million Thermo Tech shares for 5 persons in 108 transactions and by selling 121 million shares for 5 persons in 182 transactions.

¶ 21 Research Capital earned commissions of $42,320 on these 290 trades. Half of this amount was paid to the brokers whose clients did the trading. According to Research Capital's compliance director, 80 per cent of the remainder went to overhead, leaving a profit of $4,400 on the trading.

¶ 22 Of the five persons who traded, only two were residents of British Columbia. One of them bought and sold 100,000 shares and the other bought and sold 8,000 shares. The commissions on these trades totalled $150. The other three clients, which traded the vast majority of the shares, were entities outside British Columbia that traded through brokers in the Vancouver office.

¶ 23 Research Capital admits that it contravened the orders. It says it was unaware of the orders, that the contravention was inadvertent and that it would not have happened if Thermo Tech had been listed on a Canadian exchange, which would have halted trading when the cease trade order was issued.

¶ 24 On February 27, 2003, Market Regulation Services, Inc., a recognized self regulatory organization, launched a national cease trade order database on its web site to make current information on orders available to registered dealers. (We understand the database was funded, at least in part, with the money paid in the first and second settlements referred to above.) Research Capital gave evidence that the database shows more than 4,000 cease trade orders outstanding in Canada during the period when it breached the orders against Thermo Tech.

Analysis

¶ 25 Staff argue that a substantial penalty is warranted against Research Capital. They refer to the criteria set out in the commission's decision *Re Eron Mortgage Corp.,* [2000] 7 BCSC Weekly Summary 22, and suggest that the following criteria (excluding general deterrence, which the Court of Appeal has determined we cannot consider) are relevant in this case:

- The seriousness of the respondent's conduct and damage done to the integrity of the capital markets in British Columbia by the respondent's conduct;
- The extent to which the respondent was enriched;
- Factors that mitigate the respondent's conduct.

¶ 26 Staff say that the conduct of Research Capital in contravening the orders, and in failing to have systems to ensure it would be aware of and not contravene cease trade orders, did serious damage to the integrity of the market. Staff particularly pointed out that cease trade orders, and other decisions and regulatory requirements, can not be effective in protecting investors and the integrity of the market if registered dealers either ignore, or through lack of internal controls, fail to comply with these requirements.

¶ 27 Staff say that Research Capital was enriched by the $42,320 it received in commissions for the illegal trades and should be held to account for the full amount.

¶ 28 Staff say there are no mitigating factors in this case.

¶ 29 Staff say the conduct of Research Capital was more serious than that reflected in the previous settlements with other dealers that also traded Thermo Tech shares. In particular, staff cited the large volume of trades (much larger than in the third settlement, which was the only one where the volume was disclosed) and the fact that Research Capital continued trading in Thermo Tech shares even after the other dealers were disciplined and up until the staff began the investigation of Research Capital.

¶ 30 Staff submit that an appropriate sanction for Research Capital would be

- a reprimand;
- an administrative penalty of $60,000; and
- payment of costs of the proceedings.

¶ 31 Research Capital argues for a much lower penalty. It says, on the basis of the Supreme Court of Canada decision in the *Asbestos* case (discussed below) that we can impose regulatory sanctions only if we conclude, on the basis of Research Capital's past conduct, that future misconduct is likely and that the sanctions are necessary to prevent that misconduct.

¶ 32 Research Capital says that, although it did contravene the orders, there are significant mitigating factors:

- the contravention was inadvertent, resulting from a systemic breakdown that also affected 18 other firms;
- the contravention would not have occurred if Thermo Tech had been listed on a Canadian exchange;
- all but a few of the trades Research Capital executed were for non-residents of British Columbia, and could have been executed legally through any Research Capital office outside the province;
- there is no evidence that investors or market integrity were harmed;
- Research Capital earned a net amount of only $4,400 on the trades;
- Research Capital has no past disciplinary history and cooperated with the investigation;
- Research Capital's conduct poses no risk of future harm to the capital markets, particularly with the introduction of a cease trade order database that will assist firms in avoiding inadvertent contraventions.

¶ 33 On that basis, Research Capital argues that, if any sanction is to be imposed on it, it should range between a compliance order and an administrative penalty of $21,160, with the most appropriate penalty being $5,000.

Decision

¶ 34 The Supreme Court of Canada reviewed the purpose of regulatory enforcement orders in *Committee for the Equal Treatment of Asbestos Minority Shareholders v. Ontario (Securities Commission)*, [2001] 2 S.C.R. 132. In that case, a group of minority shareholders appealed a decision by the OSC to decline to issue enforcement orders against the government of Québec despite the government's unfair treatment of those shareholders when it acquired control of Asbestos Corporation in 1982. The Court dismissed the appeal on the basis that the OSC had properly exercised its discretion and that its decision was reasonable.

¶ 35 In considering how the OSC exercised its discretion, the Court analyzed the purpose of the regulatory enforcement powers under the Ontario *Securities Act*, which are similar to the powers under our Act. The following comments, drawn

from paragraphs 42 to 45, set out the Court's view of regulatory (or administrative) enforcement provisions:

> 42. … [I]t is important to recognize that s. 127 is a regulatory provision. In this regard, I agree with Laskin J.A. that "[t]he purpose of the Commission's public interest jurisdiction is neither remedial nor punitive; it is protective and preventive, intended to be exercised to prevent likely future harm to Ontario's capital markets" (p. 272). … The focus of regulatory law is on the protection of societal interests, not punishment of an individual's moral faults: see *R. v. Wholesale Travel Group Inc.*, [1991] 3 S.C.R. 154, at p. 219.
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> 43. … The enforcement techniques in the Act span a broad spectrum from purely regulatory or administrative sanctions to serious criminal penalties. The administrative sanctions are the most frequently used sanctions and are grouped together in s. 127 as "Orders in the public interest". Such orders are not punitive: *Re Albino* (1991), 14 O.S.C.B. 365. Rather, the purpose of an order under s. 127 is to restrain future conduct that is likely to be prejudicial to the public interest in fair and efficient capital markets. …
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> 45. In summary, pursuant to s. 127(1), the OSC has the jurisdiction and a broad discretion to intervene in Ontario capital markets if it is in the public interest to do so. However, the discretion to act in the public interest is not unlimited. In exercising its discretion, the OSC should consider the protection of investors and the efficiency of, and public confidence in, capital markets generally. In addition, s. 127(1) is a regulatory provision. The sanctions under the section are preventive in nature and prospective in orientation. Therefore, s. 127 cannot be used merely to remedy *Securities Act* misconduct alleged to have caused harm or damages to private parties or individuals.

¶ 36 It is important to recognize the context of *Asbestos*: an appeal in which a group of investors was seeking regulatory intervention to further the investors' cause in seeking redress from the Québec government. The Court agreed with the OSC that the purpose of its enforcement powers is to protect investors and the market, not *merely* to remedy the consequences for particular investors of past misconduct. (Although the point is not relevant in the current case, the Court's use of the word "merely" here recognizes that providing a remedy for harm or damages suffered by investors could be a secondary objective of a regulatory enforcement order.)

¶ 37 The Court of Appeal for British Columbia subsequently applied *Asbestos* in *Re Cartaway Resources Corporation,* 2002 BCCA 461. At paragraph 95, the Court of

appeal said, in referring to *Asbestos*:

> Specifically, the Court confirmed that the purpose of the Commission's 'public interest' jurisdiction is neither 'remedial nor punitive' but 'protective and preventative' in that it is to be exercised to restrain *future* conduct of the *respondent* that is likely to prejudice the public interest in fair and efficient capital markets.

¶ 38 Then, at paragraph 98, Court of Appeal said:

> On the authority of the *Asbestos* case, then, past misconduct is relevant only to the extent that it may lead the Commission to conclude that future misconduct by the respondent … is likely.

¶ 39 The past conduct under review here is Research Capital's failure to comply with a cease trading order. The contravention was inadvertent, not intentional, and Research Capital was one of many firms that contravened the same order. The creation of the new database *should* make it easier for Research Capital to avoid this particular type of contravention in the future.

¶ 40 However, we take a somewhat broader view of the contravention.

¶ 41 Registered investment dealers play a critical role in the securities market. Legislation generally requires that securities trades be done through registered dealers, because they are required to act in the interests of their clients and protect the integrity of the market generally. Because of this special role, the commission authorizes a firm to carry on the business of a dealer only if its owners, management and representatives pass appropriate background checks and have the requisite training. A registered dealer must also maintain adequate capital and comply with prescribed standards of business conduct. Section 44 of the *Securities Rules*, BC Reg. 194/97, requires a registered dealer to "establish and apply written prudent business procedures for dealing with clients in compliance with the Act and the regulations."

¶ 42 The Supreme Court of Canada, in *British Columbia Securities Commission v. Branch*, [1995] 2 SCR 3 at para. 59, commented on the role of voluntary compliance in the regulatory system:

> [T]he *Securities Act* is essentially a scheme of economic regulation which is designed to discourage detrimental forms of commercial behaviour. The provisions provided by the legislature are pragmatic sanctions designed to induce compliance with the Act. After all, the Act is really aimed at regulating certain facets of the economy and

> business. This has obvious implications for the nation's material prosperity: *Thomson Newspapers.* As such, ***the effective implementation of securities legislation depends on the willingness of those who choose to engage in the securities trade to comply with the defined standards of conduct.*** [Emphasis added.]

¶ 43 The cease trade order is one of the commission's most important tools for enforcing compliance but an order is effective only if registered dealers comply with it. Research Capital admits that it contravened the orders against Thermo Tech shares but tries to minimize the importance of the contravention.

¶ 44 We accept that Research Capital did not intentionally contravene the orders and that it was one of many dealers whose compliance systems failed to stop trading in Thermo Tech. It seems probable that the trades would not have happened if Thermo Tech had been listed on a Canadian exchange, not because of anything in Research Capital's systems but because the exchange would have suspended trading.

¶ 45 However, these were not a few isolated trades that slipped through the net. Research Capital executed 290 trades through its British Columbia office over a period of 2 years, from February 2000 to February 2002, and the volumes were large: purchases of 96 million shares and sales of 121 million shares. Moreover, the trades continued even after commission staff entered into two public settlement agreements with a total of 17 other dealers and posted those agreements on the commission's web site.

¶ 46 Research Capital asks us to disregard all but the few trades that were for two British Columbia residents, saying that the others could have been done legally through its offices elsewhere. We reject that position. The trades were done through the British Columbia office and the firm has an obligation to comply with regulatory requirements here.

¶ 47 It might be less likely, now that the database has been created and Research Capital is aware of the issue, that Research Capital will contravene a cease trade order in the future. However, Research Capital still has to fix its compliance systems to ensure that this does not happen again. More important, Research Capital profited from the contravention and, in our view, the contents of the affidavit of its compliance director that it submitted as evidence showed that the firm does not take seriously the fact that it contravened regulatory orders.

¶ 48 In our view, it is important that we impose regulatory orders to induce future compliance by Research Capital with the defined standards of conduct for registered dealers and, specifically, with the requirement in British Columbia to

establish and apply "prudent business procedures for dealing with clients in compliance with the Act and the regulations."

¶ 49 The sanctions imposed through the settlement agreements with other firms that contravened the orders are of little help to us in determining appropriate orders for this case. For the first two settlements, we do not know the amount of trading or the commissions received by the firms involved. We do know the volume of trading for the third settlement but it was miniscule and isolated compared with the trading in this case.

¶ 50 We think it is appropriate to demand that Research Capital be accountable for fixing its compliance systems and to impose a financial penalty sufficient to remove any benefit the firm received on the illegal trading. Research Capital argued that, in assessing the benefit it received, we should consider only a net amount, after deducting the payout of half of the commissions to salespersons and considering the cost of general firm overheads. Those are internal firm matters that we consider irrelevant to our determination of the appropriate penalty.

¶ 51 Accordingly, we consider it in the public interest to make the following orders:

1. Under section 161(1)(f) of the Act, we reprimand Research Capital and order that its continued registration is conditional on its

   - preparing a report on changes it has made to its compliance systems to prevent its representatives from trading in contravention of British Columbia cease trading orders and

   - filing the report with the secretary to the commission within six months of this decision, together with evidence that the report is satisfactory to the Investment Dealers Association and Market Regulation Services Inc.

2. Under section 162 of the Act, we order that Research Capital pay an administrative penalty of $40,000.

3. Under section 174 of the Act, we order that Research Capital pay prescribed fees or charges for the costs of, or related to, the hearing.

¶ 52 We will consider written submissions before making an order for costs. We direct commission staff to file their submissions and send a copy to Research Capital by March 31, 2004. We direct Research Capital to file its submissions and send a copy to commission staff by April 21, 2004.

¶ 53 February 27, 2004

¶ 54 **For the Commission**

Douglas M. Hyndman
Chair

Joan L. Brockman
Commissioner

Robert J. Milbourne
Commissioner