An update on self-regulation in the Canadian securities industry (2009-2016): funnel in, funnel out, and funnel away

By Mark Lokanan

1. Introduction

The Investment Industry Regulatory Organization of Canada (IIROC) is a non-profit, national self-regulatory organization (SRO) that is responsible for policing debt and equity trading in Canada's market places. IIROC currently has 28,000 registrants approved to work with its registered Member firms. As a national SRO, IIROC is responsible for setting its own education standards and regulatory requirements. Registered representatives and their respective Member firms are expected to comply with these standards and requirements or face disciplinary sanctions ranging from fines to permanent bans from the Association for non-compliance.

When IIROC replaced the Investment Dealers Association (IDA) in June of 2008, its justification for the name change was to free itself from the IDA's baggage of lax regulation and weak enforcement (Lokanan, 2017a; Williams, 2012). As such, it is expected that IIROC with its increased enforcement budget and mandate, will continue to work with the provincial securities commissions, the RCMP's Integrated Market Enforcement Team (IMET) and other SROs to protect investors and increase inefficiency in Canada's capital markets. However, anecdotal evidence posits that IIROC is not holding registrants accountable to law and ethical standards (Gray and McFarland, 2017a, 2017b; Robertson and Cardoso, 2017). As a matter of fact, investors are still being swindled of their life savings by their advisors (Johnson, 2017) and punishment for such contraventions remains lax and inadequate (Lokanan, 2015a; Gray and McFarland, 2017a). Given that Canada does not have a national securities regulator, the investment industry is now in a precarious position and expects IIROC to take regulatory action on its registrants to ensure that their deficiencies are addressed and resolved.

On the basis of data from IIROC's annual enforcement report, the present study will employ the SRO misconduct funnel that was developed by Brockman and McEwen (1990) and further refined by Brockman (2004) and Lokanan (2015a) to examine the enforcement of complaints by IIROC from 2009 to 2016. The misconduct funnel is the white-collar crime version of the crime funnel that was developed to show how the number of cases involving street crime shrinks as they are processed from arrest to sentencing through the criminal justice system (CJS) (Lokanan, 2015a, p. 457). In the same manner, the misconduct funnel shows the disposition of complaints from case assessment to prosecution through the SROs' enforcement system and is built on three fundamental concepts: "funnel in", "funnel out" and "funnel away" (Brockman and McEwen, 1990; Brockman, 2004; Lokanan, 2015a).

"Funnel in" tests the claim made by SROs that they enforce more complaints than would not have otherwise been enforced by government regulators (Brockman and McEwen, 1990, p. 3). "Funnel out" examines the prospects of offenders who might escape formal disciplinary actions and the potential leniency of penalties imposed on those who are formally sanctioned (Brockman, 2004, p. 73). "Funnel away" examines the claim that SROs may divert cases with criminal elements away from the CJS to protect their members (Brockman and McEwen, 1990, p. 3). Given these claims, this paper attempts to answer the following questions: to what extent is IIROC holding market participants accountable to law and ethical standards?

In evaluating this question, the study makes two interrelated contributions to theory and practice. First, the study contributes to the literature on securities fraud and transgression in financial markets/security trading by examining the enforcement practices of the SRO that are at the forefront of regulating market participants in Canada - IIROC. Second, the issues discussed in this study are of significance to the wider public and policy interests in Canada. Canada is the only

G7 country without a national securities regulator. As such, it is hard not to see the results from this study being part of a wider discussion by legislators in Ottawa to show the significance of a national securities regulator.

The rest of the paper proceeds according to the following format. The first section provides a brief overview of IIROC's position in the wider context of securities regulation in Canada. The second section provides a critical review of the theoretical foundation and extant literature on self-regulation. The third section briefly describes the methodology used to collate and assemble the data used in the study. Section four provides an analysis of the findings. Finally, section five discusses the findings in relation to the literature and concludes by highlighting areas for future research.

2. Literature Review

2.1 Self-regulation and Industry Regulation

The theory of self-regulation is often touted as superior to government regulation, because self-regulatory regimes are able to scrutinize a wider variety of behaviours and achieve greater inspectorial depth than government regulation (Aussenegg, Jelic, and Ranzi, 2018; Lokanan, 2017a). SROs claim to “funnel in” and address more cases than public regulators through their enforcement systems (see Lokanan, 2014). Given that market fraud, integrity of financial reporting, and mis-selling are seen as some of the most significant ethical issues facing global financial markets, it would seem prudent to have industry members who are close to the issues brought about by these misconduct to address them (Cumming, Dannhauser, and Johan, 2015). As a matter of fact, recent research has shown that about 14% of firms engage in some form of market abuse (see Dyck, Morse, and Zingales, 2013). The overburdened criminal justice system (CJS) does not have the capacity to deal with the volume of market abuse cases, and unless they are very serious, the police will not touch these crimes (Williams, 2012; Lokanan, 2017a). By virtue of their

specialized knowledge, SROs operating in financial markets may well be in a better position to “funnel in” more cases and address the misconduct that the police choose not to investigate (Brockman, 2004; Lokanan, 2015a). To facilitate the “funneling in” of more complaints, there needs to be more formalized cooperation between differing securities market authorities to effectively engage in the surveillance of market abuse (Cumming et al. 2018; Lokanan, 2015b).

Despite the arguments for industry self-regulation, the dynamics of the financial services professions and the evolving nature of the industry itself, makes the justifications for self-regulation somewhat hollow (Jordan and Hughes, 2007, p. 212). The most common criticism of SROs is that they are too lenient on their members and, rather than imposing proportional penalties for rule violations, they are being accused of imposing penalties that are so light, that they amount to nothing more than a regulatory wrist slap (Aussenegg et al., 2018; Brockman, 2004; Lokanan, 2014a). More recent findings show that the intensity of enforcement is the most statistically robust and economically significant predictor of market abuse (Cumming, Groh, and Johan, 2018). The governance of private enforcement, which is largely dominated by a homogenous group of players (such as large investment firms and banks), is partly the reason why the big players in the industry escape proportional sanctions (Lokanan, 2017b; Stenfors, 2018; Williams, 2018). These are all informed traders that predict the profits from corporate misconduct both in the short and long run (Bernile et al., 2015; Cummings et al., 2015). Altogether, it takes a combined effort by authorities to detect fraud and one cannot merely rely on regulators to catch all financial misconduct (Cumming, Johan, & Peter, 2018; Dyck et al., 2013; To, Treepongkaruna, and Wu, 2018).

A parallel criticism of SROs is that they deflect criminal complaints away from the CJS to protect their members from criminal prosecution (Brockman, 2004, p. 57). Complaints deflected from the CJS are more serious in nature and involve the selling of risky products and illegal bid spreads (see Cumming et al., 2018; Stenfors, 2018; Lokanan, 2017b). The introduction of

innovative financial products such as Credit Default Swaps and Asset-Back Commercial Papers (ABCP), along with manipulation and bid-ask spreads in foreign exchange swap markets, have complicated the types of products that financial institutions now deal with (Cummings et al., 2018b; Lokanan and Sharma, 2018; Stenfors, 2018; To et al., 2018). Market participants looking to maximize their bottom line, package these products as securities and sell them to investors with zero or very little knowledge of the associated risks (Lokanan, 2017a; To et al., 2018). The financial penalties for these types of market abuses are higher than the more service type offences (see Lokanan, 2015a; 2017a). It may be that for these more serious offences, that enforcement was more vigorous because the minimum pecuniary fines per offence are usually higher (Cumming et al., 2018a; Lokanan, 2017b). In dealing with serious market abuse through private enforcement, SROs enmesh themselves in a conflict-of-interest by trying to protect their members and the public at the same time. The two eventually cannot be reconciled and may implode to the detriment of the public interest.

2.2 Differential Enforcement of Market Abuse and Global Finance

The International Financial Crisis (IFC) is widely recognized to have started in 2007 and became more pronounced in 2008. The IFC was accompanied with allegations of market misconduct and differential enforcement by country standards. In Canada, the enforcement mosaic, namely the Office of the Superintendent of Financial Institutions (OSFI), (as sponsors of commercial papers), the securities commissions (for conduits as issuers), and the SROs (for investment advisors as dealers), all served as authorities in charge of regulating financial institutions and their members (Cumming et al., 2015; Lokanan, 2015a; Williams, 2012). To a large extent, these regulators were all at fault for exposing investors to risky financial products through various investment vehicles, without conducting their collective due diligence on their suitability for investors (see Cumming et al. 2018b).

Canada is not unique in this governance structure that exacerbates financial market misconduct. The sub-prime mortgage crisis in the U.S. was partly blamed for the mixture of centralization and dispersion of authority of market regulation (Bernile, Sulaeman, and Wang, 2015; Lokanan, 2015b). In the U.S., the regulation of financial intermediaries is spread across the Federal Reserve, the Federal Deposit Insurance Corporation, the Office of the Controller of the Currency, and the Office of Thrift Supervision. In stark contrast to Canada, the regulation of the securities market is centralized at the SEC, who delegates self-regulatory duties to the Financial Industry Regulatory Authority (FINRA). This “peculiar mix” of private sector self-regulation, delegated governmental regulation, and government regulation worked together to derail effective regulation (Agrawal and Cooper, 2015; Karmel, 2008; To et al., 2018). Nowhere was this more evident than the sale of sub-prime derivatives leading up to the IFC in 2008. The deregulation push weakened banking industry regulations. This allowed commercial and investment banks to co-mingle with each other to create complex derivatives called Collateral Debt Obligations (CDO’s) and Collateralized Loan Obligations (CLOs). Investment brokers in the U.S. and all over the world, marketed these products to investors who themselves did not understand them (Aitken, Cumming and Zhan, 2015; Lokanan, 2017a; Cumming et al., 2015). Both government regulation and self-regulation were seen as equally responsible for the fiasco.

Unlike Canada and the U.S., the U.K., has a much stronger consolidation of regulatory authority under the the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA). In the U.K. model, the Bank of England is in charge of financial stability, while prudential and market conduct regulations of market participation and financial institutions are centralized under the FCA. This tripartite regulatory structure is partly to blame for some of the market abuse in the U.K. (Aussenegg et al., 2018; Cumming et al., 2018a). In institutional apparatus with inter-agency conflict, formalized cooperation is an important tool for effective

regulation of the financial markets (Cumming et al., 2015; Lokanan, 2015b). The FCA, as custodian of the financial system, has the unique advantage of being in a position to set industry standards and make sure that its members comply with those standards; but it has adopted a philosophy, which is to look at specific aspects of the market in isolation, rather than the aggregate picture. The LIBOR scandal and the manipulation of the FX swap market are examples of the FCA not looking systematically at financial market regulations (Lokanan and Sharma, 2018; Stenfors, 2018). These practices are inconsistent with the rules governing the financial industry, and provide further evidence that regulators – both SROs and the state -- wiped their hands of these issues until it was too late (Aussenegg, 2018; Cumming et al., 2018a; Lokanan, 2015a).

2.3 Enforcement of Market Abuse

Canada's fragmented system of provincial securities regulators, police, and SROs makes it difficult to share data in a centralized pool in order to obtain an accurate picture on the enforcement of financial market misconduct by regions (Lokanan, 2017b; Williams, 2012). That said, one indicator the Canadian Securities Association (CSA)¹ uses to gauge the level of enforcement activities in Canada is to look at the number of offences commenced and prosecuted by regulatory authorities. The CSA, in its 2016 annual enforcement report, noted a year-on-year increase in enforcement proceedings. According to the CSA, the three key SROs in Canada's securities industry regulatory landscape - IIROC, the Chambre de la Sécurité Financière (CSF) and the Mutual Fund Dealers Association of Canada (MFDA), concluded 159 enforcement cases in 2016, compared with 139 cases in 2015 (CSA, 2016, p. 21). Also present is an increased focus on quasi-criminal proceedings. In 2017/18, the "courts in Alberta, Ontario, and Québec ordered jail terms under their respective securities acts. According to the CSA, 19 individuals received a total of over 29 years of jail time (17 individuals received over 33 years of jail time for the calendar

year)” (CSA, 2018, p. 23). Eight cases were commenced under the *Canadian Criminal Code* by the provincial regulators (p. 24). In total, 11 individuals were found guilty under the *Criminal Code* - one each in British Columbia and Manitoba, three in Ontario, and six in Québec. Eight offenders received jail sentences totaling 14 years of jail time (p. 24). The sentences ranged from six months to four years (p. 24).

Policing the markets has always been a priority for those in charge of securities regulation in the U.S. The Securities and Exchange Commission (SEC), FINRA, and the listing exchanges have all been lauded for more vigorous enforcement of financial market abuse (Bernile et al., 2015; Bhattacharya, 2006; Lokanan, 2015a). The SEC’s strong crime control model, supported by a healthy budget and government support, allowed its enforcement team to bring 754 enforcement actions against market participants in 2017, down from 784 in 2016 (Securities and Exchange Commission, 2017, p. 6). Out of these, 196 were bars based on the Commission’s actions or action by the justice system and other regulators (p. 6). These results are not surprising considering that the SEC has jurisdictional reach, the financial resources, regulatory technology, and analytics to tackle financial misconduct (Bernile et al., 2015; Agrawal and Cooper, 2015). The SEC also has a strong extra-territorial presence and can take over cases that domestic regulators do nothing about.

Prior to the harmonization of rules governing the European securities market, it was very difficult to analyze market abuse across countries (Cumming et al., 2018a). Harmonization, the Markets in Financial Instruments Directive (MiFID II) and the Market Abuse Regulation (MAR) in Europe, have made it easier to analyze the enforcement of market abuse in the European countries (Aussenegg et al., 2018). While space does not permit a detailed analysis of the enforcement statistics of European countries, it would appear from the literature that has been assembled to date, that the intensity of enforcement and cooperation between securities market authorities are significant predictors of market abuse detection (Aussenegg et al., 2018; Cumming et al., 2018a;

Stenfors, 2018). Penalties have also become harsher under this new cooperative framework. For example, a breach of securities laws can lead to permanent bans, incarceration, and large financial penalties for offenders charged with serious market abuse offences (Aussenegg et al., 2018). For example, the LIBOR manipulation established the largest fraud activities in Europe to date (see Cumming et al., 2018; Lokanan and Sharma, 2018; Stenfors, 2018). Record fines and other non-monetary sanctions were imposed on the market participants who were found guilty of manipulating the markets in the LIBOR scandal (Cummings et al., 2018).

Taken together, Canada's patchwork regulation and differential enforcement methods shape its lax regulatory penalties in market abuse cases. The SEC (as a centralized agency) on the other hand, has a long history of rigorous enforcement, while the FCA and the European regulators have a much shorter track record of success. The main point to be taken here is that there is no tailor made method to detect and prevent market abuse. Rather, securities regulators the world over, must endeavour to embrace regulatory approaches that are unique to their jurisdictions and operations. Irrespective of the approach taken, the focus must be on protecting investors and holding individuals accountable to law and ethical standards.

3. Methodology

Data for the study came from IIROC's enforcement annual reports. Data were collected from 2009 (the first year of IIROC's operation) to 2017. Three types of enforcement data were collected: data on complaints, data on violations and data on sanctions imposed on registrants. Data on complaints show the sources of the complaints and the most common types of complaints received by IIROC. The data on complaints also show the number of complaints that were assessed at the case assessment stage and then made their way through to investigations and prosecutions.

Data on violations were collected for infractions committed by IIROC’s individual registered representatives and Member firms. This type of data shows the types and frequency of offenses committed by IIROC’s representatives. Data on penalties imposed were collected for both individual offenders and Member firms. Enforcement data were collected for both monetary (i.e., fines, cost, disgorgement) and non-monetary (i.e., suspension, bans, warning letters and termination) penalties imposed on registrants.

4. Findings

Proposition 1: IIROC “funnel in” and scrutinizes on a wide variety of complains and ensure higher standards than government regulators.

Figure 1 shows the main sources of complaints that were “funneled in” from the Complaints and Settlement Reporting System (ComSet). ComSet’s share of complaints in 2009-2016 varied from 73% to 83% of the total number of complaints received. The next important source of complaints is the Public, which fluctuated from a high of 18% in 2009 to a low of 14% in 2016. Note also that the total number of complaints was generally decreasing during the period analyzed, with 2,536 complaints received in 2009 and only 1,459 complaints received in 2016.

Figure 1: Sources of complaints

Figure 2 shows the most common type of complaints received by case assessment staff for the time period under examination. Unauthorized and discretionary trading complaints were at a high in 2009 (369) before they declined to 12 in 2016. IIROC's increased scrutiny of suitability issues over the past five years may have led to cases previously identified as unauthorized trading to be processed as suitability issues (Langton, 2013, para. 13). Complaints related to misrepresentation declined from 335 in 2009 to seven in 2016. There are a couple of other caveats to these numbers that are worth explaining. In 2011, IIROC changed its complaints handling procedures. Up to that point, IIROC's enforcement department dealt directly with all public complaints. In mid-2011, IIROC formed a new internal complaints handling team to filter complaints so that enforcement staff only deal with cases involving genuine regulatory issues (Langton, 2013, para. 13). As such, the overall decline in the top three complaints may be the result of IIROC's new procedures to handle public complaints.

Figure 2: Top Three Complaints Received by IIROC

Proposition 2: Offenders escapes disciplinary sanctions by being “funneled out” from IIROC’s enforcement system and the potential for leniency exists when penalties are imposed for their misconduct.

4.2 From Complaints to Investigation and Prosecution

Once a case enters the enforcement system, there is the possibility that the offender may escape disciplinary sanctions by being “funneled out” with light regulatory penalties (Brockman, 2004; Lokanan, 2015a). Before the complaints meet a hearing panel, they must first go through additional hurdles in the investigation and prosecution stages (Brockman, 2004, p. 73). Figure 3 below shows that the number of initial complaints shrinks significantly from the complaints stage before they reach investigation and prosecution. As is clear from Figure 3, the share of investigations completed seems to be decreasing with time, possibly because they were funneled out at the complaint stage (Lokanan, 2015a). Notably, this is accompanied with the decrease in the total number of complaints received – but notes also that the number of investigations completed is falling even faster, resulting in this decreasing share of investigations completed.

Figure 3: Number of complaints that reached investigation and prosecution by year.

It should be pointed out that investigations and prosecutions are carried out with some time lag after the corresponding complaint was received.² As such, the high number of investigations in 2010 (425 investigations) might be due to the high number of complaints (that spilled over from) the previous year – 2009 (2,536 complaints). This may explain the high proportion of investigations in 2010 (23%), as well as the low proportion of prosecution decisions in 2009 (2%). It could be that investigation staff did not receive all the evidence and/or had the time and resources to deal with all of the complaints in 2009. The decisions rendered, therefore, most likely include complaints received in previous years.

The next step of the analysis includes tracking of the flow of complaints for the whole period 2009-2016. As can be seen in Figure 4, from the total number of 13,793 complaints received during this period, only 1,767 (13%) investigations were completed and 457 (3%) prosecution decisions were rendered. Considering IIROC's claim that it takes complaints handling seriously, Figure 4 shows that the number of complaints shrinks significantly from the initial complaints to investigations and then to prosecutions.

Figure 4: Number of complaints that reached investigation and prosecution in 2009-2016

4.3 The Funnel Process: Funnel Away

Proposition 3: To protect its members from coming into contact with the Criminal Justice System (CJS), IIROC “funnel away” criminal code complaints by dealing with them internally.

The “funnel away” component of the regulatory funnel is concerned with the deflection of complaints from the CJS by SROs (Brockman and McEwen, 1990; Lokanan, 2015a). Under this claim, it is expected that IIROC will deal with cases involving fraud, misappropriation of funds and forgery internally rather than sending them to the CJS for criminal prosecution (Lokanan, 2015a). As can be seen in Table 1, IIROC’s enforcement department “funneled away” about 9% of cases involving criminal elements – misappropriation of funds, forgery and fraud. By definition, these are all criminal code offenses and should have been referred to the CJS for criminal prosecution (see Lokanan, 2015a). One can infer from these findings that registrants are involved in widespread criminal practices and very few end up in a criminal court. The most striking feature is not so much in the proportion of a single type of offenses committed by individual offenders, but the seriousness of the types of offenses that IIROC dealt with internally.

Table 1: Proportion of different types of individual violations

VIOLATIONS	2009	2010	2011	2012	2013	2014	2015	2016	AVG
Suitability/due diligence	30.0%	18.1%	22.7%	28.0%	29.2%	25.0%	27.9%	26.8%	26.0%
Inappropriate financial dealings	12.5%	12.0%	10.2%	10.8%	10.8%	6.9%	8.8%	9.9%	10.2%
Misrepresentation	7.5%	10.8%	5.7%	9.7%	4.6%	11.1%	7.4%	4.2%	7.6%
Discretionary trading	0.0%	4.8%	5.7%	6.5%	7.7%	6.9%	13.2%	14.1%	7.4%
Unauthorized trading	0.0%	6.0%	8.0%	6.5%	1.5%	13.9%	8.8%	9.9%	6.8%
Supervision	10.0%	2.4%	5.7%	4.3%	6.2%	8.3%	7.4%	9.9%	6.8%
Failure to cooperate	10.0%	8.4%	8.0%	2.2%	4.6%	6.9%	2.9%	7.0%	6.3%
Misappropriation	5.0%	2.4%	5.7%	8.6%	4.6%	1.4%	1.5%	5.6%	4.4%
Gatekeeper	10.0%	7.2%	5.7%	3.2%	3.1%	2.8%	5.9%	0.0%	4.7%
Forgery	2.5%	4.8%	2.3%	6.5%	4.6%	5.6%	7.4%	0.0%	4.2%
Manipulation/deceptive trading	0.0%	2.4%	10.2%	4.3%	4.6%	1.4%	1.5%	4.2%	3.6%

Off book transaction	5.0%	7.2%	3.4%	1.1%	7.7%	2.8%	0.0%	1.4%	3.6%
Outside business activities	0.0%	1.2%	2.3%	4.3%	6.2%	4.2%	2.9%	5.6%	3.3%
Trading conflict of interest	0.0%	4.8%	0.0%	2.2%	0.0%	0.0%	2.9%	0.0%	1.2%
Trading without registration	2.5%	3.6%	2.3%	1.1%	0.0%	0.0%	0.0%	0.0%	1.2%
Undisclosed conflict of interest	5.0%	2.4%	0.0%	0.0%	0.0%	0.0%	1.5%	1.4%	1.3%
Trading order violations	0.0%	0.0%	2.3%	1.1%	0.0%	0.0%	0.0%	0.0%	0.4%
Fraud	0.0%	1.2%	0.0%	0.0%	3.1%	0.0%	0.0%	0.0%	0.5%
Inadequate books and records	0.0%	0.0%	0.0%	0.0%	1.5%	2.8%	0.0%	0.0%	0.5%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%

There are many other types of violations committed by individual offenders, but most of them are quite rare. What is most striking in Table 1 is the number and type of cases IIROC is taking on. IIROC seems to have stepped up enforcement on suitability cases that involve more serious wrongdoing and causes the most financial harm to market participants (Langton, 2013; Lokanan, 2015a). For individuals, suitability/due diligence violations are the most common violations, accounting for 26% of all individual offenses and vary significantly from a high of 30% in 2009 to about 27% in 2016, with fluctuations in-between years. This is not surprising taking into consideration that suitability violations were the complaint most often documented at the case assessment stage. Another offense type that was registered very often between 2009 and 2016 is “Inappropriate financial dealings.” As can be seen in Table 1, inappropriate financial dealings vary consistently between 2009 and 2016. Note also that, during the last years (2015-2016), the proportion of “Discretionary trading” violation increased and become the second most widespread offense type, accounting for 13-14% of the total number of individual violations. Other violations do not show any noteworthy trends or patterns and do not exceed ten cases per year.

For firms, violations related to supervision were much more frequent. As can be seen in Table 2, the supervision offenses increase steadily from 2010 to 2016, from a low of 33.3% to a high of 50% (41.9% on average). That said, however, capital deficiency violations outweighed supervision issues in 2009, when seven such cases were registered (43.8%). In total, capital deficiency offenses accounted for 15.3% of all firm violations, on average. Violations related to internal controls offense occurred regularly between 2009 and 2016 and accounted, on average, for 13.3% of all firm violations during the period examined.

Table 2: Shares of different types of firm violations

VIOLATIONS	2009	2010	2011	2012	2013	2014	2015	2016	AVG
Supervision	37.5%	33.3%	36.0%	47.6%	41.7%	41.7%	47.1%	50.0%	41.9%
Capital deficiency	43.8%	0.0%	16.0%	4.8%	33.3%	0.0%	11.8%	12.5%	15.3%
Internal controls	18.8%	16.7%	12.0%	9.5%	16.7%	8.3%	11.8%	12.5%	13.3%
Expedited hearing - winding down	0.0%	0.0%	0.0%	14.3%	8.3%	33.3%	17.6%	12.5%	10.8%
Inadequate books and records	0.0%	0.0%	16.0%	4.8%	0.0%	16.7%	11.8%	0.0%	6.2%
Failure to handle clients' accounts	0.0%	16.7%	8.0%	9.5%	0.0%	0.0%	0.0%	12.5%	5.8%
Failure to meet best price obligations	0.0%	33.3%	12.0%	9.5%	0.0%	0.0%	0.0%	0.0%	6.9%
Total	100%	100%	100%	100%	100%	100%	100%	100%	100%

4.4 Correlations

Next, correlations of the different types of violations were analyzed. Figure 5 shows the top-12 type of violations for both individuals and firms. The correlation matrix in Figure 5 depicts visually as well as numerically the magnitude (or strength) of correlation between top investment violations. The size of the circles reflects absolute value of correlation. Positive relationships are depicted with blue color and negative relations are depicted with red color. The significance of the correlation can be seen in Table 5 below. A p-value that is below 0.05 (marked with red in the table) indicates that the correlation is significant.

As can be seen in Figure 5 and Table 3, the cases with criminal elements that are funneled away from the CJS show high positive correlations with other regulatory offenses. A high positive correlation is observed between forgery and misrepresentation violations (0.75). Misappropriation is also highly correlated with inappropriate financial dealings (0.68) and manipulation/deceptive trading (0.63). In terms of the other significant violations, individual supervision violations show significant negative correlation (-0.76) with gatekeeper violations. Consequently, the more supervision violations are observed, the less is the number of gatekeeper violations in the respective year. Additionally, higher number of individual supervision violations is associated with higher number of discretionary trading violations (0.57), lower number of inappropriate financial dealings (-0.5) and lower number of misrepresentations (-0.4). Note also that the much more grey area offenses, such as unauthorized trading violations, are associated with discretionary trading (0.55). Only one type of firm violations appeared to be in the top-12 violations by quantity, and that is violations related to supervision issues (supervision firm as named in the figure below). This is not surprising considering that supervision was the top offense that IIROC's Member firms violated (e.g., see Lokanan, 2015a).

Figure 5: Correlation matrix for top-12 individual and firm violations

Table 3: P-values for the correlations between top violations

	<i>Discretionary trading</i>	<i>Failure to cooperate</i>	<i>Forgery</i>	<i>Gatekeeper</i>	<i>Inappropriate financial dealings</i>	<i>Manipulation/deceptive trading</i>	<i>Misappropriation</i>	<i>Misrepresentation</i>	<i>Suitability/Due Diligence</i>	<i>Supervision</i>	<i>Supervision Firm</i>
<i>Failure to cooperate</i>	0.120										
<i>Forgery</i>	0.718	0.071									
<i>Gatekeeper</i>	0.000	0.172	0.260								
<i>Inappropriate financial dealings</i>	0.190	0.580	0.224	0.051							
<i>Manipulation/deceptive trading</i>	0.858	0.462	0.235	0.971	0.092						
<i>Misappropriation</i>	0.690	0.196	0.567	0.645	0.044	0.013					
<i>Misrepresentation</i>	0.233	0.952	0.002	0.051	0.068	0.310	0.973				
<i>Suitability/Due Diligence</i>	0.045	0.004	0.179	0.103	0.505	0.385	0.003	0.891			
<i>Supervision</i>	0.001	0.439	0.084	0.000	0.007	0.989	0.884	0.013	0.374		
<i>Supervision Firm</i>	0.612	0.004	0.248	0.565	0.756	0.291	0.010	0.706	0.004	0.747	
<i>Unauthorized trading</i>	0.014	0.913	0.879	0.035	0.150	0.389	0.414	0.872	0.513	0.023	0.477

4.5 Sanctions

4.5.1 Costs, fines and disgorgement

IIROC hearing panels imposed both monetary (costs, fines, disgorgement) and non-monetary (suspensions, conditions, warning letters, permanent bar and termination) sanctions for transgressions. The analysis on penalties starts with the financial sanctions. As is evident from Figure 6, the main financial sanction imposed on both individuals and firms was fines. The total amount of fines imposed is much higher than the amount of costs and disgorgements.

Figure 6: Total amount of costs, fines and disgorgement for individuals and firms in 2009-2016

Given that the total amount of financial sanctions depends not only on the size of the fines, costs and disgorgement, but also on the number of cases, an analysis of the average amounts of different financial sanctions imposed on the offenders was conducted. As can be seen in Figure 7, for individual offenders, the total amount of all financial sanctions imposed within one decision was equal to \$103K, on average. Average costs and disgorgement were more or less equal throughout the period analyzed, while fines were significantly higher on average during 2011-2013

with the maximum average fine being \$194K in 2012. The lowest average amount of fines applied to individuals was observed in 2009 (\$54.8K).

Figure 7 also shows the financial penalties imposed on firms. The total amount of all financial sanctions imposed within one prosecution decision was equal to \$383K, on average. It should be noted that the average is overestimated here due to unusually high fines in 2009 (\$2.17M). Thus, for the period 2010-2016, the average amount of all financial sanctions applied per one case would be \$124K. Similar to the individuals' cases, the average costs and disgorgement for firms did not vary much during 2009-2016.

Figure 7: Average amount of costs, fines and disgorgement for individuals and firms in 2009-2016

The seemingly tougher line taken on individuals is not reflected in IIROC's action against Member firms (see also Langton, 2013). As can be seen in Table 4, the number of decisions taken against Member firms declined significantly to six in 2016 from a high of 15 in 2019. IIROC it appears, seems to be going after individual offenders more vigorously, rather than the root causes of the problem, the Member firms.

Table 4: Number of Decisions for both Individual and Firms

	2009	2010	2011	2012	2013	2014	2015	2016
Individuals Offenders								
Decisions	28	45	58	58	45	47	40	50
Firms								
Decisions	15	6	18	17	12	10	12	6

Figure 8 presents the fine collection rates for both individual offenders and Member firms. Interestingly, the fine collection rate differs significantly between firms and individuals. While firms almost always pay most of their fines (collection rate varies between 74% in 2017 and 100% in 2013 – 2014, 2016), individuals are unlikely to repay the full amount of fines imposed (see Williams, 2012; Lokanan, 2015a). A closer look at Figure 8 shows that the fine collection rate varies from a low of 8.3% in 2016 to a high of 21.3% in 2014 and then decreases again to about 10% in 2017.

Figure 8: Fine collection rate for individuals and firms in 2012-2017

Figure 9 shows the amount of fines imposed and collected for both individual offenders and Member firms. Note that the average amount of fines imposed per year (for all individual advisors cases) was \$4,726K, while the average amount of fines collected per year (for all cases) was \$758K. The average amount of fines collected per case was \$16.5K. Fines imposed against

individual advisors went unpaid because IIROC does not have the statutory authority to go after offenders (Lokanan, 2017a; Robertson and Cardoso, 2017). Furthermore, an advisor who had been disciplined by IIROC “could evade his or her penalties by leaving the investment industry” indefinitely (Langton, 2017, para. 8). Member firms pay their fines because they have to comply with IROC rules to stay in business or face permanent suspension (Lokanan, 2014a; Shecter, 2017).

Figure 9: Amount of fines imposed and collected from individuals and firms in 2012-2016

4.5.2 Non-monetary Sanction

Considering IIROC’s inability to collect fines from individual offenders, the size of the fines imposed can be a misleading indicator of enforcement intensity (Langton, 2013, para. 9). The other major sanction that IIROC has in its enforcement arsenal is to kick wayward offenders out (permanent bars) or sideline them through a suspension. As can be seen in Figure 10, the use of suspension rose steadily before decreasing in 2016. Although the use of permanent bars declined starting from 2010, temporary suspension rose notably from year-over-year. The increase in suspension orders indicates that violators are not just losing money; they are also costing them time away from the industry (Langton, 2013, para. 11). However, the tougher stance against individual

misconduct does not seem to be applied to Member firms. A closer look at Figure 10 shows that permanent suspension was used more often than termination to secure compliance (see Lokanan, 2015a).

Figure 10: Sanctions for individuals (right chart) and firms (left chart) in 2009-2016

4.6 Correlations

In this part of the analysis correlations between different sanctions for both individuals and firms were analyzed. The results are depicted on the correlation matrices in Figure 10, while the p-value for the correlation is shown in Table 5. For individual sanctions, the following significant correlations are observed at $p\text{-value} < 0.05$. There seems to be a weak negative correlation between number of suspensions and average costs (-0.49) and number of conditions and permanent bars (-0.45). Figure 10 also show a strong positive correlation between number of conditions and average disgorgement (0.69).

Figure 10: Correlation matrix for individual sanctions. **Table 5:** P-values for the correlations between individual sanctions

Figure 11 presents the correlation matrix for sanctions imposed on firms at p-value < 0.05). There is a strong positive correlation between average fines and cost (0.76). This finding indicates that IIROC’s hearing panels may impose harsher fines for investigations that are costly. There are negative correlations between average costs and number of terminations (-0.45) and between number of terminations and permanent suspensions (-0.41).

Figure 11: Correlation matrix for firm sanctions **Table 6:** P-values for the correlations between firm sanctions

	<u>Average costs</u>	<u>Average disgorgement</u>	<u>Average fine</u>	<u>Permanent suspension</u>
<u>Average disgorgement</u>	0.100			
<u>Average fine</u>	0.017	0.065		
<u>Permanent suspension</u>	0.187	0.588	0.280	
<u>Termination</u>	0.037	0.338	0.134	0.028

5. Discussion and Conclusion

This study employed the SRO’s misconduct funnel to examine the processing of complaints from initial screening to final case disposition by IIROC’s enforcement team. While there is no basis on which to compare whether IIROC “funneled in” more complaints than government regulators, the findings indicate that ComSet were able to handle a significant

proportion of complaints in a timely manner. IIROC, it seems, is better able to position itself to scrutinize a wider variety of complaints through the ComSet reporting system and, in so doing, achieve greater inspectorial depth than government regulators (Williams, 2012; Lokanan, 2017a). It is hard to fathom that government regulators will address 13,793 regulatory complaints during the period examined in this study. Additionally, compliance issues relating to complaints from client to Member firms are also reported through ComSet. The existence of so many sources for investors to report complaints is in itself significant.

That said, a significant proportion of complaints were “funneled out” at the investigation and prosecution stages of the enforcement process. As was evident in Figure 4, investigation only received 13% of the cases that came through IIROC’s reporting system and only 3% made their way through to prosecution. These findings imply that about 97% of the cases were “funneled out” by the time they reached prosecution. The funneling out of cases before they reach a hearing panel gives the appearance of lenient enforcement and sends the wrong message about IIROC’s seriousness to protect the public interest (Johnson, 2017).

The claim that SROs “funnel away” complaints with criminal elements attached to them seems to have merit in IIROC’s enforcement of complaints. While only three (0.5%) fraud cases were funnelled away during the time period examined, 26 (4.4%) misappropriation and 25 (4.2%) forgery or falsification of documents cases were dealt with internally by IIROC’s enforcement staff. IIROC may have legitimate reasons to address these cases internally because IMET cannot be bothered to look at complex criminal capital market fraud offenses (Rosen and

Rosen, 2010; Williams, 2012). However, others argue that these cases are dealt with internally because of the difficulty in securing a conviction in criminal courts (Gray and McFarland, 2017a; Lokanan, 2017a). Many Crown attorneys operating with scarce resources prefer cases with sound bites (e.g., stabbing or shooting) rather than capital market fraud cases where the evidentiary burden makes them difficult to prosecute (Gray and McFarland, 2017a, para. 29).

It should not be a surprise then that the cases which end up at the bottom of the misconduct funnel involve fraud, forgery and misappropriation of funds (Lokanan, 2015a). Indeed, these are the most serious cases and undoubtedly have negative impacts on investors and the financial markets. The fact that they are the most egregious cases, however, does not mean that they are more significant from a regulatory perspective (Lokanan, 2015a, p. 475). While the harm to investors from these fairly conventional criminal activities may be significant, they are “dwarfed by the much larger problem of unsuitable investment advice as well as unauthorized and discretionary trading” cases that make up about 40% of the cases that the IIROC dealt with between 2009 and 2016 (Lokanan, 2015a, p. 475).

Fines imposed pale in comparisons to the maximum fines per contravention. Considering that a maximum of \$5 million in fines can be imposed per offense and the average fines imposed on disciplined individuals and Member firms were \$103K and 383K, respectively, per decision, this only equates to two and eight percent of the proportion of fines imposed. Such lax enforcement does not send a sufficiently strong deterrent message that IIROC is serious about protecting investors from unscrupulous investment advisers (Rosen and Rosen, 2010; Williams,

2012; Lokanan, 2014a). A closer look at Table 1 shows that more than 50% of all violations committed by individual offenders involved suitability requirements, misrepresentation, discretionary and unauthorized trading. These are very serious offenses whose frequency of occurrence drives prosecution activities (Lokanan, 2017a). Yet, the penalties imposed are not proportionate to the harm caused by these offenses.

The top two Member firms' offenses made up 57% of all offenses that IIROC dealt with. Not surprisingly, they are supervision and capital deficiency offenses, both of which have been flagged previously as "hot spots" that IIROC needs to address (Lokanan, 2015b; 2017a). As was pointed out in earlier research of the IDA (Rosen and Rosen, 2010; Williams, 2012; Lokanan, 2014a; 2015b; 2017a), without robust enforcement, the rules do not matter. Given how few investors' complaints made it to the bottom of the funnel, one would expect firms to be more vigilant with employees' supervision. The real issues, it would seem, lie with dealer compensation practices and weak (and even conflicted) supervision that incentivizes investment representatives who maximize the firms' bottom line (Lokanan, 2014a; 2017a).

Another key issue from the findings is fine collection. As can be seen in Figure 8, Member firms almost always pay their fine, while individual offenders pay a fraction of the fines levied on them. These findings indicate that IIROC's system of compliance is not providing enough deterrence to make a dent in financial crimes in Canada. Recognizing the impact of unpaid fines, investors' advocacy groups and the IIROC have been advocating for legal authority to collect outstanding fines in courts so that it can more effectively enforce its rules on offenders

in a consistent manner. IIROC has been successful in securing legal authority to go after unpaid fines in Ontario, Alberta, Quebec, Prince Edward Island, Manitoba, and British Columbia. The real issue, however, is who gets the money when unpaid fines are collected? Will the increased funds be available for investor protection? Will they be distributed to investors who lost money from these investment scams? These are all questions that can form useful research agendas.

5.1 Limitations of the Study

The study suffers from a few limitations. First, the paper only looks at data that were initially assessed by IIROC from various sources and made their way through its enforcement system. The cases where firms underreported complaints to ComSet or chose to deal with them internally is missing from the analysis (Lokanan, 2017a). Second, the paper only deals with cases that came to the attention of IIROC's case assessment team and are considered regulatory matters, which, in effect, limits the referrals sent through to enforcement (Karpoff et al., 2004). The paper does not deal with cases that were referred to the CJS and provincial securities commission for criminal or regulatory actions (Karpoff et al., 2004; Lokanan, 2015a). Third, the data does not include extraneous cases; rather, the data deal with enforcement outcome only (i.e., disciplinary actions taken against individual offenders and Member firms) (Lokanan, 2017a).

¹ The CSA is the umbrella organization for Canada's provincial securities regulators

² Even though investigations completed and prosecution decisions rendered are analyzed as share from the complaints received, it is believed that, due to the time lag, these investigations/prosecutions are not only from the

current year. In other words, prosecution decisions rendered in 2016 might be for the complaints received in 2014-2015.

Reference

- Aitken, M., Cumming, D., & Zhan, F. (2015). "Exchange trading rules, surveillance and suspected insider trading", *Journal of Corporate Finance*, <https://doi.org/10.1016/j.jcorpfin.2015.07.013>
- Agrawal, A., & Cooper, T. (2015). "Insider trading before accounting scandals", *Journal of Corporate Finance*, <https://doi.org/10.1016/j.jcorpfin.2015.07.005>
- Aussenegg, W., Jelic, R., & Ranzi, R. (2018). "Corporate insider trading in Europe", *Journal of International Financial Markets, Institutions & Money*, <http://dx.doi.org/10.1016/j.intfin.2017.05.004>
- Bernile, G., Sulaeman, J., Wang, Q. (2015). "Institutional trading during a wave of corporate scandals: 'Perfect Payday'?", *Journal of Corporate Finance*, 34, 191–209.
- Bhattacharya, U. (2006). "Enforcement and its Impact on Cost of Equity and Liquidity of the Market", Available at SSRN: <http://ssrn.com/abstract=952698>
- 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*, Vol. 19, No. 1, pp. 55-84.
- Brockman, J., and McEwen, C. (1990). "Self-regulation in the legal profession: funnel in, funnel out, or funnel away?", *Canadian Journal of Law and Society*, Vol. 5, No. 1, pp. 1-46.
- Canada Securities Administrator. (2016). "CSA 2016 Enforcement Report", available at: [https://www.securities-administrators.ca/uploadedFiles/General/pdfs/CSA_AnnualReport2016_English_Final\(1\).pdf](https://www.securities-administrators.ca/uploadedFiles/General/pdfs/CSA_AnnualReport2016_English_Final(1).pdf) (accessed 12 September 2018).
- Canada Securities Administrator. (2018). "CSA 2017/2018 Enforcement Report", available at: http://www.csasanctions.ca/CSA_201718_Enforcement_Report_Desktop.pdf (accessed 12 September 2018).

-
- Canada Securities Administrator (CSA). (2018). "Upholding the Law: Enforcing the rules, holding people to account", available at: <https://www.securities-administrators.ca/enforcement.aspx?id=73> (accessed 10 January 2018).
- Cumming, D., Dannhauser, R., & Johan, S. (2015). "Financial market misconduct and agency conflicts: A synthesis and future directions", *Journal of Corporate Finance*, <https://doi.org/10.1016/j.jcorpfin.2015.07.016>
- Cumming, D., Groh, A., & Johan, S. (2018a). "Same rules, different enforcement: Market abuse in Europe", *Journal of International Financial Markets, Institutions & Money*, <https://doi.org/10.1016/j.intfin.2018.03.006>
- Cumming, D., Johan, S., & Peter, R. (2018b). "Developments in financial institutions, governance, agency costs, and misconduct", *Journal of International Financial Markets, Institutions & Money*, <http://dx.doi.org/10.1016/j.intfin.2017.06.004>
- Dyck, A., Morse, A., & Zingales, L. (2013). How Pervasive is Corporate Fraud?. Available at SSRN: <https://ssrn.com/abstract=2222608> or <http://dx.doi.org/10.2139/ssrn.2222608>
- Gray, J., and McFarland, J. (2017a). "Crime without punishment: Canada's investment fraud problem", *The Globe and Mail*, available at: <https://www.theglobeandmail.com/report-on-business/crime-and-no-punishment-canadas-investment-fraud-problem/article13938792/> (accessed 19 December 2017).
- Johnson, E. (2017). "I trusted him with my money': Woman says broker 'churns' her account, rakes in over \$250,000." Canadian Broadcasting Corporation, available at: <http://www.cbc.ca/news/canada/british-columbia/financial-advisor-earns-quarter-million-in-commissions-1.4328616> (accessed 11 October 2017).
- Jordan, C., and Hughes, P. (2007). "Which Way for Market Institutions: The Fundamental Question of Self-Regulation." *Berkeley Business Law Journal*, Vol. 4, No. 2, pp. 205-226.
- Karmel, R. (2008). "Should Securities Industry Self-Regulatory Organizations be Considered Government Agencies?", *Stanford Journal of Law, Business & Finance*, Vol. 14, pp. 151-215.

-
- Karpoff, J. M., Koester, A., Scott, L., and Martin, G. (2004). "Database Challenges in Financial Misconduct Research", Georgetown McDonough School of Business Research Paper No. 2012-15. Available at SSRN: <http://dx.doi.org/10.2139/ssrn.2112569>
- Langton, J. (2013). "IIROC gets tough on enforcement", *Investment Executive*, available at: https://www.investmentexecutive.com/newspaper_/news-newspaper/iroc-gets-tough-on-enforcement/ (accessed 26th April 2018).
- Langton, J. (2017). "IIROC's big jump in enforcement activity", *Investment Executive*, available at: https://www.investmentexecutive.com/newspaper_/news-newspaper/iroc-s-big-jump-in-enforcement-activity/ (access 26th April 2016).
- Lokanan, M. E. (2014a). "The Investment Dealers Association of Canada's Enforcement Record: Are Penalties "Grossly Inadequate?", *Journal of Financial Regulation and Compliance*, Vol. 22, No. 3, pp. 235-251.
- Lokanan, M.E. (2015a). "Self-Regulation in the Canadian Securities Industry: Funnel In, Funnel Out, or Funnel Away?", *International Journal of Law, Crime and Justice*, Vol. 43, No. 4, pp. 456-480.
- Lokanan, M.E. (2015b). "Securities Regulation: Opportunities Exist for IIROC to Regulate Responsively", *Administration and Society*, doi: 10.1177/0095399715584637
- Lokanan, M.E. (2017a). "Self-regulation and compliance enforcement practices by the Investment Dealers Association in Canada: 1984 to 2008", *Journal of Financial Regulation and Compliance*, Vol. 25, No. 1, pp. 2 – 21
- Lokanan, M.E. (2017b). "Regulatory Capture of Regulators: The case of the Investment Dealers Association of Canada", *International Journal of Public Administration*. DOI: 10.1080/01900692.2017.1385623
- Lokanan, M.E., & Sharma, S. (2018). "A Fraud Triangle Analysis of the Libor Fraud", *Journal of Forensic and Investigative Accounting*, Vol. 10, No. 2, pp. 187-212.
- McCaffrey, D., and Hart, D. (1998). *Wall Street Polices Itself: How Securities Firms Manage the Legal Hazards of Competitive Pressures*. Oxford University Press: New York.

-
- Ontario Securities Commission. (2018). “Our regulatory powers”, available at: http://www.osc.gov.on.ca/en/Investors_qc-regulatory-powers.htm (accessed 18 February, 2017).
- Robertson, G., and Cardoso, T. (2017). “Canada’s \$1.1-billion problem: Regulators dish out big fines but only collect a fraction”, *The Globe and Mail*, available at: <https://www.theglobeandmail.com/news/investigations/billion-dollars-unpaid-fines-white-collar-crime/article37416140/> (accessed 12 March 2018).
- Rosen, A., and Rosen, M. (2010). *Swindlers: Cons and Cheats and How to Protect Your Investments from Them*. Toronto, ON: Madison Press Limited.
- Securities and Exchange Commission. (2017). “Annual Report: A Look Back at Fiscal Year 2017”, available at: <https://www.sec.gov/files/enforcement-annual-report-2017.pdf> (accessed 13 September 2017).
- Shecter, B. (2017). “Ontario to give regulators power to use courts to collect fines”, *Financial Post*, available at: <http://business.financialpost.com/news/fp-street/ontario-to-give-regulators-power-to-use-courts-to-collect-fines> (accessed 26th April 2018).
- Stenfors, A. (2018). “Bid-ask spread determination in the FX swap market: Competition, collusion or a convention”, *Journal of International Financial Markets, Institutions & Money*, <https://doi.org/10.1016/j.intfin.2017.08.001>
- To, T., Treepongkaruna, S., & Wu, E. (2018). “Are all insiders on the inside? Evidence from the initiation of CDS trading and short selling in the financial sector”, *Journal of International Financial Markets, Institutions & Money*, <https://doi.org/10.1016/j.intfin.2017.05.003>
- Williams, J. (2012). *Policing the Markets: Inside the Black Box of Securities Enforcement*, London: Taylor and Francis Ltd.