Securities enforcement: Big win and broader tools for regulators

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From 2012 to 2014, Canadian securities regulators commenced 27.5% fewer proceedings and concluded 22.2% fewer cases. Given this backdrop, developments in 2015 – including the highly anticipated decision in Finkelstein [PDF], along with the Ontario Securities Commission’s (OSC) proposed Whistleblower Program and the recent availability of “no-contest” settlements – could mark a change for securities enforcement in Canada.

EVIDENTIARY STANDARD FOR INSIDER TRADING AND TIPPING

After an extended period of mixed success by Canadian securities regulators in prosecuting capital markets wrongdoing, including setbacks in 2014 in Re Jowdat Waheed and Bruce Walter [PDF] and Walton v. Alberta (Securities Commission) [PDF], the OSC scored a significant victory in 2015 in the Finkelstein decision. Although it is now under appeal, the ruling holds promise for regulators launching future administrative proceedings against persons alleged to have engaged in insider trading and tipping.

In Finkelstein, an OSC panel found that Toronto lawyer Mitchell Finkelstein and four investment advisors breached Ontario’s Securities Act by engaging in insider trading and tipping. In its decision, the panel highlighted that Finkelstein’s position as a lawyer put him in a special relationship with the reporting issuers. As a partner in a Bay Street law firm, he misused his crucial gatekeeping role by disclosing confidential information.

In many insider trading and tipping cases, only the offenders themselves will have actual knowledge of the relevant communications. This makes direct evidence for tipping and trading offences rare and successful prosecutions difficult. The OSC panel in Finkelstein overcame this difficulty by relying on circumstantial evidence to draw inferences that material non-public information had been shared and received, allowing them to conclude on a balance of probabilities that violations of the Securities Act had occurred. This lower evidentiary standard allowed OSC staff to secure convictions in Finkelstein, but underscores the regulators’ need to be cautious in pursuing administrative proceedings and ensuring sufficient procedural safeguards during the proceeding itself.

The OSC has had some success in other administrative – as opposed to criminal – settings by relying on circumstantial evidence, as it did in Finkelstein. A similar finding was made in Re Aunqueci et al. [PDF], which is also under appeal (Osler represents one of the appellants). However, there are mixed views in
Canadian securities law generally on the extent to which and situations in which circumstantial evidence can be used.

For example, the Alberta Court of Appeal's 2014 decision in Walton, from which the Supreme Court of Canada refused to grant leave to appeal, suggests that something more than mere circumstantial evidence is needed to meet the evidentiary standard to secure a conviction. This decision is directionally more consistent with recent experience in the United States. While downstream tippees in Finkelstein were found liable for insider trading, those in United States v. Newman and Chiasson [PDF] were not, as the Court in Newman seems to have imposed an increased burden on prosecutors to demonstrate that the tippees had knowledge that the tipper received an impermissible personal benefit, and not merely that the tipper disclosed material non-public information. The Supreme Court of the United States recently refused to hear the federal government's challenge of the decision in Newman. The possible sea change resulting from Newman and the mixed record in Canada suggest that there is room for appellate review and clarification.

PROPOSED WHISTLEBLOWER PROGRAM’S IMPLICATIONS FOR CULTURE OF COMPLIANCE

The OSC hopes that its enforcement efforts will be enhanced with its proposed Whistleblower Program, which seeks to motivate reporting of securities law violations by offering monetary awards to whistleblowers. The current proposal, which is still in its draft form, reflects changes that the regulator made in light of public comments on its earlier proposal.

While the OSC’s proposed program would be the first in Canada, the United States already has a program for whistleblowing that was created by the Dodd-Frank Act. In fiscal year 2015, the SEC received a total of almost 4,000 tips from whistleblowers, a 30% increase since fiscal year 2012. Tips received from abroad, however, declined slightly; the SEC received 421 tips in fiscal year 2015, a 6% decrease since fiscal 2014. Of the tips received from abroad in fiscal 2015, 49 were from Canada, the second-highest foreign source of whistleblowing tips to the SEC after the United Kingdom.

Eligibility for financial rewards under the OSC’s proposed program would require that whistleblowers have credible and detailed information that the regulator currently does not have, and that the information provided must lead to the commencement of an OSC proceeding. The new proposal also extends eligibility to culpable whistleblowers and in certain circumstances to employees involved in compliance, oversight and audit roles – for example, 120 days after they first reported the information through the proper internal channel.

If the information provided by a whistleblower leads to monetary sanctions or voluntary payments in excess of $1 million, then the whistleblower would be entitled to an award between 5% and 15% of the total sanctions or payments, for an award up to $5 million. This award cap was raised from $1.5 million following public comments, but is contrasted with the American model where there is no cap on the total reward that may be payable. In the fiscal year 2015, the SEC paid more than US$37 million in rewards to eight whistleblowers, for an average reward of over US$4.6 million. In one of those cases, the SEC paid more than US$30 million to a single whistleblower. The OSC’s proposed program seeks to avoid payments of this magnitude by introducing a proportionally smaller reward scale and the maximum reward cap.

While whistleblowing awards could create incentives for persons with inside knowledge of securities violations to come forward, tying reward amounts to penalties awarded potentially poses problems in that it reflects and perpetuates a misalignment in the traditional functions of Canadian securities
regulators, which is to prevent and protect capital markets from misconduct. The focus of the Whistleblower Program should be to drive the behaviour of registrants towards increased compliance, which respects the core tenets of the OSC’s traditional enforcement mandate, instead of punishing bad behaviour.

Concern has also been expressed that the program may undermine businesses’ internal reporting and compliance programs by giving incentives to employees to bypass these channels entirely and go straight to the OSC in the hope of pocketing a significant monetary award. While the OSC says that it will encourage reporting internally, there is still no requirement that employees first use available internal channels – or provide proof as to why there were good reasons not to – before they are eligible for a whistleblowing reward. In our view, imposing this condition is vital if the OSC wants to encourage a corporate culture of compliance, and the absence of such a requirement could undermine the essential role of internal compliance and complaint procedures in ensuring robust compliance with securities law.

Confidentiality risks also pose a unique challenge to the proposed Whistleblower Program. While the OSC intends to use all reasonable efforts to keep confidential the identities of whistleblowers, there are certain permitted exceptions for disclosure, such as when it would be necessary to allow a person charged with a securities law violation to make full answer and defence or to advance the goals of securities legislation. These categories are extremely broad and vague. Disclosure may advance prosecutorial goals in certain proceedings, but the risk that a whistleblower’s identity could be disclosed may correspondingly deter the whistleblower from coming forward.

NO-CONTEST SETTLEMENTS – A FURTHER ADDITION TO THE ENFORCEMENT TOOLKIT

The proposed Whistleblower Program comes after the OSC made “no-contest” settlements available in 2014, and is part of a recent trend of expanding the OSC’s enforcement toolkit. Aimed at improving the regulator’s enforcement capability, no-contest settlements allow the alleged wrongdoer in administrative proceedings to settle without admitting to an offence. Last November, the OSC approved a significant $13.5 million no-contest settlement with entities related to TD Waterhouse regarding excess client fees that the TD entities themselves had discovered and reported. The TD settlement underscores the need for market registrants to maintain strong internal systems to comply with securities law, and showcases the OSC’s role in protecting investors and facilitating fair and efficient capital markets.

The outcome of the appeal in Finkelstein and the final shape of the proposed Whistleblower Program could have significant ramifications for the enforcement of securities law in Canada. While this may improve enforcement capabilities and the success of prosecutions, Canadian regulators should still be wary of overstepping their traditional enforcement mandate in favour of a more punitive approach towards securities violators.
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