Submission to the Expert Panel on Securities Regulation

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This document outlines, first, the characteristics of effective regulation overall; second the essential ingredients for financial services and securities regulation.

The regulatory agency has become an essential tool of governance today. In a wide variety of sectors, governments attempt to direct and control the activities of business through different statutory regimes, via agencies using strategies ranging from friendly advice to criminal charges. The targets of regulation, the companies in each sector, respond to government regulation in a variety of ways, from total engagement/compliance to overt or covert resistance and defiance. Overall levels of compliance vary, first, with the history and internal organization of a particular business, its sector, size, profitability and geographic location; second with the characteristics of the regulatory agency, specifically its size, history and resources; and third, with the nature and strength of 3rd parties invested in the regulatory process – for example, NGOs, trade and professional associations, pressure, interest and protest groups (Braithwaite & Drahos, 2000; Gunningham et al, 2003; Gunningham & Johnstone, 1999; Shapiro, 1984; Hutter & Jones, 2006; Hall & Johnstone, 2005; Noble, 1985, 1986; Simpson & Grabosky, 1995; Haines, 2003; Parker, 2002; Purcell et al, 2000; Shover et al, 1986 Simpson, 2002; Vaughan, 1998; Sanchez, 1998; Post, 1998).

Because the Panel has no mandate to tackle the internal organization of companies, fixing the regulatory process and institutionalizing 3rd party involvement must be its primary foci. It has become increasingly obvious that incorporating non-governmental third parties, parties that do not represent the interests of either business/industry or government, is an essential component of effective, efficient regulation. Third parties have already been incorporated into many other regulatory sectors: environmental groups are represented as stakeholders in the Canadian Environmental Protection Act, patient groups are intermediaries between hospitals and medical associations, unions between employers and government in occupational health and safety regulation. Comparable regulatory systems elsewhere (see Pamela Reeve's Submission on the Financial Services Consumer Panel in the United Kingdom) have successfully incorporated the most logical third party, the retail investor, into financial regulation. Canada is one of the few Anglo-

American, common-law systems of financial regulation still reliant on an outdated bipartite model of regulation.

Decades of study by scholars in a number of disciplines have documented the “added value” of structurally incorporating third parties into regulatory systems (Ayres and Braithwaite 1992; Braithwaite and Grabosky 1993; Clinard and Yeager 1980; Coleman 1987; Condon 1998; Daniels and Macintosh 1991; Daniels and Morck 1996; Grabosky 1995; Gunningham and Johnstone 1999; Parker 2006; 2002). From the pioneering work of Australian sociologists/criminologists John Braithwaite and Peter Grabosky – see their studies in *Corporate Crime: Contemporary Debates* (eds. L. Snider & F. Pearce, University of Toronto Press, 1995) - to U.S political scientist Malcolm Sparrow, Canadian regulatory gurus such as Bruce Doern (School of Policy Studies, Carleton University), Stefan Wood (Osgoode Hall Law School, Toronto), and Joan Brockman (School of Criminology, Simon Fraser University), there is near-universal consensus – an unheard of phenomenon in the contentious the academic world. In the words of Peter Grabosky:
"Overt enforcement of law is but one element in a web of constraint, some of whose strands are barely discernible, and many of which are non-governmental." (1995)

When integrated into the regulatory equation third parties play a vital role in mitigating the phenomenon of “capture”, a well-documented and virtually inescapable fact of regulatory life (Ayres and Braithwaite 1992; Snider 1993; Coleman 1987; Parker 2002). In the literature “capture” refers to the tendency of the regulatory agency to adopt the position, and identify with the interests of the regulated. It occurs over time, when regulators and the regulated come to know each other too well. Thus each party can anticipate the position of the other and incorporate it into the regulatory agenda. This creates an overly cautious regulatory system, one that loses track of the larger *public interest* the agency was established to represent.

Inserting third party interests into the system short-circuits “capture”, introduces new voices, different stakeholders, and brings the larger public interest back in. However to be effective, third parties must be “embedded”, that is, they must be in a position to “observe regulatory decision-making processes, monitor regulatory treatment and disposition of complaints, or force the hand of regulators." (Sparrow, 2000). Logistically this means they must have the power to take issues to a higher authority such as an independent civilian oversight board, and/or to the public through media, if they feel the interests of the stakeholders they represent or the larger public interest are in jeopardy.

Even more crucially, they must be funded: there is presently no funding available for third-party non-governmental oversight of securities regulation and enforcement (i.e. by consumer/retail investors or representative groups). Thus far this essential public role has fallen, by default, to hard working, hard pressed voluntary groups such as the Small Investor Protection Association run by Stan Buell and InvestorVoice.ca run by Rob Kyle (both established in 1998).

The role of third parties is particularly significant in a regulatory environment where

there have been problems with weak enforcement. Securities regulation is Canada is certainly one such entity (Nicholls 2006; Sibold 2005; Andrews 2006; Snider 1993, 2005, 2006a, 2006b, 2008). The history of Bill C-13, the failure of the RCMP's Integrated Market Enforcement Teams (IMET), and the fragmented nature of stock market regulation in Canada – the only developed country without a federal securities regulatory body (Phelps et al. 2003) – have critically weakened investor confidence in Canada's markets. Again we see near-universal consensus among the experts, in this instance on the lenience, uncertainty, expense and delay that characterize Canadian stock market regulation. As Cory and Pilkington (2007) conclude: "It is clear from publicly available sources and from our consultations as a whole, that credible and well-informed individuals sincerely believe that there have been and continue to be, serious defects in Canada's securities enforcement systems."

Introducing and institutionalizing third party involvement in securities regulation is *not* an attack on regulatory officials. Properly conceptualized and developed, third parties reinforce regulatory power. They help regulators do the job they are obligated by statute to do. Indeed, no group is more cognisant of the problems of securities regulation in Canada today than regulators – they confront the dilemmas of investor confidence, the difficulties of securing compliance and the paucity of enforcement mechanisms on a daily basis. In a recent interview study (Snider 2008), enforcement staff had no problem describing the difficulties they face. A few sample quotes:
- 'There is no meaningful deterrence' (Interview, February 2006).
- "We work hard on creating culture of compliance, [but] they develop *culture of non-compliance"* (Interview, March 2006).
- "Culture of compliance? How about a culture of *de*fiance!" (Interview, May 2006).

In democratic states today, regulation is generally cyclical. Each new corporate crisis tends to generate a new round of regulations, laws and sanctions – in securities regulation, for example, the post-2002 accounting scandals associated with Enron and Hollinger Inc which produced *Sarbanes-Oxley* in the United States, Bill C-13 and IMET in Canada. In other sectors the same phenomenon has occurred – Bill C-45 following the Westray Mining Disaster in 1993, new environmental regulations after the the Exxon Valdez oil spill. Unfortunately this has resulted, in many business sectors, in a profusion of complicated, sometimes obsolete, often contradictory regulations that benefit primarily the corporate Bar. This makes the goal of this Expert Panel, to secure maximum compliance at minimum cost, a daunting task indeed. Incorporating non-governmental third parties into financial regulation is the best way to ensure that citizen interests are represented. Indeed it is an essential component in securing an effective, publicly-responsive, cost-efficient regulatory system.

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