OSLER

Evolving capital markets regulatory enforcement

DEC 8, 2020 12 MIN READ

Related Expertise

- Anti-corruption and Bribery
- Capital Markets
- Capital Markets Regulatory Enforcement
- Corporate and Securities Disputes
- Government Investigations and White-Collar Defence
- Regulatory Investigations
- Risk Management and Crisis Response

Authors: Lawrence E. Ritchie, Shawn Irving, Fabrice Benoît, Lauren Tomasich, Frédéric Plamondon

Your browser doesn't support HTML5 audio. Here is a link to the audio instead.

Even prior to the impacts of COVID-19, change was on the horizon for capital markets enforcement in 2020. The year began with continued consideration of significant reforms to modernize the regulatory regime, as well as a heightened focus on market manipulation and abusive trading. With the onset of the pandemic, regulators adapted their enforcement efforts to a virtual world through remote investigations and electronic hearings. There was also an uptake in whistleblowing activity in the work-from-home environment.

Proposed reforms c/o the Capital Markets Modernization Taskforce

As noted in our "Reducing the regulatory burden: Positive developments in corporate and securities law in 2020" article, the Capital Markets Modernization Taskforce (the Taskforce) published its widely-anticipated Consultation Report (the Report) on July 9, 2020. If ultimately adopted by the Ontario government, several of the Taskforce's proposals would operate to significantly alter the regulatory landscape for capital markets across Ontario.

From a governance and operations viewpoint, the Taskforce addressed long-standing calls for a separation of the regulatory and adjudicative functions of the Ontario Securities Commission (the OSC or when referring to the tribunal, the Commission) through the creation of a new capital markets adjudicative tribunal as an entirely separate entity from the OSC. This bifurcation would transform the Commission into a "regulatory authority," comparable to the Financial Services Regulatory Authority of Ontario and the model advanced in the Cooperative Capital Markets Regulatory Initiative.

The Report included 12 recommendations relating to changes in capital markets enforcement and two recommendations to support enhanced investor protection. The recommendations proposed enhanced tools for OSC staff that are intended to strengthen OSC staff's ability to police the capital markets while simultaneously promoting fairness to potential respondents. Several recommendations in the Report support an increasingly aggressive stance with regard to regulatory enforcement, such as increasing the maximum administrative monetary penalties to $5 million. Additionally, the Report indicated the Taskforce's interest in adopting a number of initiatives to mirror those recently enacted in British Columbia, such as an expanded investigative authority and broader collection powers.

Notably, on the defence side, the Taskforce recommended changes aimed at liberalizing

information sharing within a hyper-confidential investigation process. The Report also introduced revisions to OSC guidelines to allow more time for investigation targets to negotiate a resolution with OSC staff prior to the commencement of proceedings.

The Taskforce further recommended a mechanism by which persons or companies subject to an OSC summons could apply to an OSC adjudicator for clarification or advice relating to the summons or examination. Absent such a process, parties seeking clarification about a summons are forced to seek directions from the courts as the OSC does not contemplate a procedure to provide such clarification. This was most recently demonstrated in the application *In The Matter of B*. In that case, the Commission considered an argument by a party that complying with a summons issued under s. 13 of the *Securities Act* would contravene other obligations that the individual was subject to under an employment agreement. The Commission held that it did not have authority to provide directions on this issue and, consequently, directed the applicant to seek guidance from the court.

Highlights of enforcement activity

On or about June 23, 2020, the Canadian Securities Administrators (the CSA) released its annual Enforcement Report for the 2019/2020 fiscal year, entitled *Collaborating to Protect Investors and Enforce Securities Law*. While there were fewer enforcement cases than the previous year, the Enforcement Report highlighted the cross-collaboration among CSA members. Notably, there were a total of 91 enforcement referrals between CSA members and 63 instances of CSA members assisting one another in enforcement cases. According to the Enforcement Report, securities regulators concluded 75 enforcement matters, resulting in around $60 million in sanctions. CSA members issued 66 investor alerts, with a particular rise in late March as the COVID-19 pandemic reportedly led to an increase in fraudulent investment schemes and misleading promotions.

Adapting to the virtual world

In light of the COVID-19 pandemic, the OSC adopted a standard practice of proceeding by way of electronic hearings, either through videoconference or teleconference. On August 5, 2020, the OSC published a "Guide to Virtual Hearings Before the OSC Tribunal" to assist parties in proceedings. Adjudicative bodies around the world have adopted similar practices. These changes can raise questions of procedural fairness and judicial economy. For further detail, see also our "Litigating during COVID-19 and other notable litigation developments in 2020[A1]" article.

In *Re First Global Data Ltd,* a decision released in September 2020, the Commission held that proceedings will be conducted electronically unless a respondent can prove on persuasive evidence a likelihood of "significant prejudice." In this case, the Commission rejected the respondents' requests that their merits hearing (involving approximately 25 witnesses over 40 hearing days) be heard in person. In its decision, the Commission emphasized the importance of conducting proceedings expeditiously, even during a pandemic. Accordingly, it rejected the respondents' arguments that *only* an in-person hearing would suffice for a complex case where serious allegations were at issue.

Given the experience that regulators and counsel are gaining in adapting to and conducting electronic hearings, coupled with the perceived efficiency of proceeding virtually, it may be that electronic hearings will be more common even after the pandemic has ended.

On April 16, 2020, the Autorité des marchés financiers (AMF), Québec's securities regulatory authority, issued a statement on its website confirming the decision to limit and adapt its

investigative activities in light of COVID-19. By way of example, the AMF raised the prospect of its investigations being conducted remotely and in a more targeted manner. Like virtual hearings, it is possible that remote investigations may remain a common tool for regulatory authorities, even after the pandemic.

Rise in whistleblower tips and awards

On April 6, 2020, the OSC announced that it had awarded C$525,000 to a company outsider who used their industry expertise to identify irregularities in the company's disclosure record. In the announcement, the enforcement team at the OSC emphasized the unique role that industry experts can play in identifying and reporting potential wrongdoing. The OSC also confirmed the robust protections that exist within the OSC Whistleblower Program.

In May 2020, the Securities and Exchange Commission (the SEC) reported a surge in whistleblower tips during the COVID-19 pandemic. Specifically, from March to May, the SEC staff triaged more than 4,000 tips, complaints and referrals, representing a 35% increase as compared to the same period last year. Factors that may be contributing to the uptick in whistleblowing are the work-from-home environment, increased privacy offered to whistleblowers and increased unemployment, emboldening former or current employees to come forward.

In September 2020, the SEC voted to adopt significant amendments to the rules governing its whistleblower program, with the aim of providing more clarity to whistleblowers and increasing efficiency and transparency. The SEC whistleblower program has awarded approximately US$676 million to 108 individuals since issuing its first award in 2012, with awards ranging from US$50,000 to US$114 million. SEC Chairman Jay Clayton has stated that the recent amendments will further incentivize tips by "get[ting] more money into the hands of whistleblowers, and at a faster pace." Some notable highlights of the amendments include a presumption of the statutory maximum amount for awards up to US$5 million; allowing awards based on deferred prosecution agreements, non-prosecution agreements or settlements; and increased flexibility in filing requirements. Whistleblower tips under the SEC program have been submitted by individuals located in the United States and 114 foreign countries.

On October 22, 2020, the SEC announced a record award of over US$114 million to an anonymous whistleblower whose tips and assistance led to successful enforcement actions by the SEC. This award far surpasses the US$50 million award paid to an individual whistleblower in June 2020, which, at that time, was the largest in the SEC's history.

Confirming a broad view of securities

On March 16, 2020, in its decision in *Ontario Securities Commission v. Tiffin*, the Ontario Court of Appeal reiterated the broad definition of "security" under the Ontario *Securities Act* (the Act) and affirmed the "catch and exclude" regime established by the Act.

In *Tiffin*, the defendants were charged with three breaches of Ontario securities law in connection with the sale and distribution of promissory notes (the Notes). In response to these charges, the defendants argued that the Notes did not constitute "securities" and, therefore, the Act did not apply. In advancing this argument, they advocated for the application of the U.S. Supreme Court's "family resemblance test" for determining whether particular debt instruments are "securities." This test presumes that a "note" is a "security" unless, based on the examination of certain specified factors, the note bears strong resemblance to one of an enumerated list of instrument types that have been recognized by

U.S. courts as not constituting regulated securities.

The Court of Appeal declined to apply the American test. Instead, the Court found that the Act employs a "catch and exclude" scheme, defining key terms broadly and then enumerating specific statutory exemptions. The Court cautioned against judicial "tinkering" with definitions central to complex regulatory schemes.

Tiffin serves as a reminder to parties involved in transactions, including lending transactions, to be cognizant of the potential application of securities laws to their conduct – including the differences in regulatory treatment of certain instruments across jurisdictions.

A change in approach to the Commission's deference?

On July 29, 2020, in the case of *Quadrexx Hedge Capital Management Ltd. v. Ontario Securities Commission*, the Ontario Divisional Court applied a re-articulated "standard of review" framework for appeals arising from decisions of the OSC. The case was an appeal from an OSC determination that the directing minds of the relevant Quadrexx entities had engaged in fraudulent conduct with respect to the distribution of securities. The appellants appealed the decision on the basis that the OSC had both committed palpable and overriding errors and denied them procedural fairness. Specifically, the appellants argued that the OSC made errors on issues of fact, mixed fact and law, and in the application of procedural fairness.

The Court reserved judgment following the argument of the appeal. Pending its decision, the Supreme Court of Canada released its landmark decision in *Canada (Minister of Citizenship and Immigration) v. Vavilov*. In *Vavilov*, the Supreme Court of Canada clarified that, when courts are faced with judicial review of an administrative action, the presumed standard is now to be "reasonableness." However, reasonableness may be displaced in various instances, including if the governing legislation provides for an express statutory right of appeal, such as in section 9(1) of the Act.

The Court in *Quadrexx* adopted the revised framework in *Vavilov,* confirming that decisions from the Commission will no longer be subject to review on a "reasonableness" standard. Instead, questions of law will attract a "correctness" standard and questions of fact or mixed fact and law will attract a "palpable or overriding error" standard. Ultimately, the Courtdismissed the appeal on the basis that the Commission did not make any errors of fact that rose to the level of palpable or overriding errors and did not deny procedural fairness.

While the *Quadrexx* appeal did not engage any pure questions of law which would have attracted review on a correctness standard, the Court's affirmative stance on the application of *Vavilov* suggests that, moving forward, certain OSC decisions could be subject to greater scrutiny on appeal. Commission rulings on questions of law, which courts might have previously affirmed as "reasonable," may not meet the higher "correctness" standard to which they will now be held.

OSC targets broad array of market activities

Throughout this past year, securities regulators in Canada have demonstrated a heightened focus on targeting market manipulation and abusive trading.

Prompted by what was described as an increasing presence of "abusive short selling" practices throughout Canada, the OSC and the Investment Industry Regulatory Organization of Canada (IIROC) issued an unusual joint press release on October 1, 2020 encouraging those with valuable information about securities violations to report tips through the OSC's

Whistleblower Program. The OSC/IIROC press release was said to be designed to send a message to the Canadian securities market that the OSC is committed to penalizing what it considers to be deceptive and manipulative market behaviour in the Canadian securities landscape.

This focus on greater market conduct regulation follows an announcement by the OSC on July 16, 2020 of a settlement with a Toronto-based cryptoasset trading platform that admitted to having developed and deployed an algorithm to assist in reporting inflated trading activity. This is the first settlement involving alleged manipulative trading on a crypto trading platform. It is also the first case alleging reprisals against a whistleblower under the Act since protections for employee whistleblowers were adopted in 2016. See also our "New opportunities and new challenges for Cryptoasset Trading Platforms [A1]" article.

The OSC has also reiterated its position that auditors are not immune from regulatory enforcement. On January 24, 2020, the OSC approved a $4 million settlement agreement with BDO Canada LLP (BDO). Specifically, BDO was penalized for its failure to comply with generally accepted auditing standards in its audit of the 2014-2015 financial statements of two investment funds managed by Crystal Wealth Management Systems Ltd. (Crystal Wealth). Due to BDO's substandard audit, certain fraudulent investments had been improperly recorded in Crystal Wealth's audited financial statements. The considerable penalty imposed by the OSC on BDO signifies its commitment to holding corporate gatekeepers accountable where companies make misrepresentations in the course of accessing, or maintaining a presence in, the public markets.

In response to what is seen as harmful and aggressive short selling activities, the Taskforce has recommended a prohibition on short selling in connection with prospectus offerings and private placements, as well as a prohibition on making misleading or untrue statements about public companies to deter and combat "short and distort" and "pump and dump" schemes.

The next year will likely be one of reform in the enforcement area. With heightened emphasis on burden reduction and regulatory harmonization (for example, the proposed amendments for a modern self-regulatory organization structure as discussed in our "Reducing the regulatory burden: Positive developments in corporate and securities law in 2020" article, post COVID-19 normalization, and consideration of the Taskforce recommendations in Ontario (which will no doubt have a pan-Canadian impact), 2021 will likely involve further introspection, assessment and action.