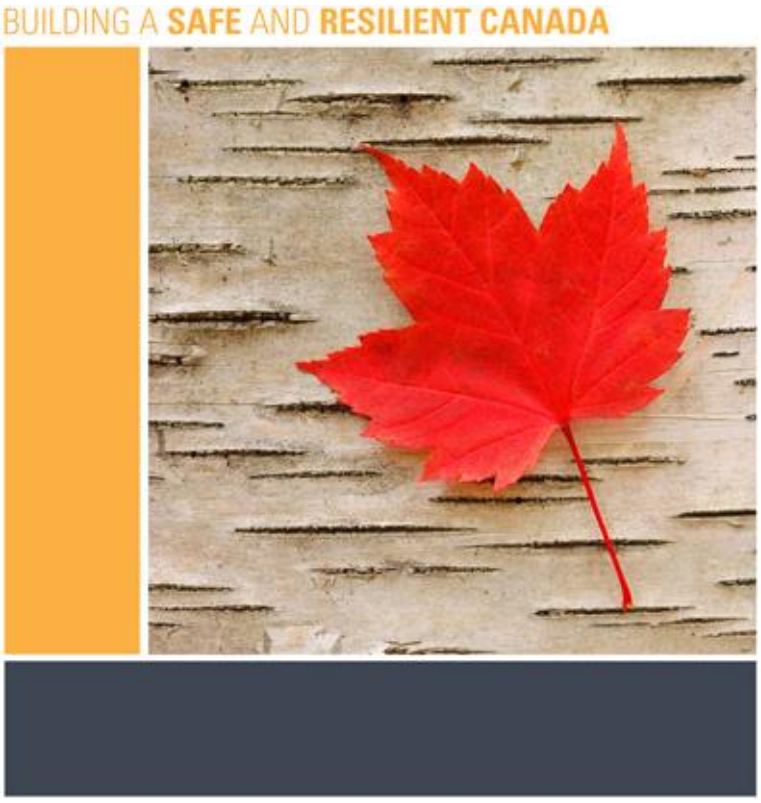

Public Safety Canada

Economic Sectors Vulnerable to Organized Crime: Securities

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Economic Sectors Vulnerable to Organized Crime: Securities

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Executive Summary

This report offers a detailed and accessible study of the vulnerabilities to organized crime affecting the securities sector in Canada. Much of the focus is directly or indirectly placed on Toronto (Ontario) and Montreal (Québec) given that these jurisdictions host and regulate the main Canadian stock and derivatives exchanges, respectively.

Since 2002 the *Criminal Code* has provided an expansive definition of organized crime/criminal organizations that includes three or more persons involved in a group that has as one of its main purposes or activities the commission of serious offences. At the time of writing, we were unable to locate any securities-related cases where a Canadian court has issued a conviction for criminal organization charges although we are aware of one pending case. There are clearly ongoing difficulties in applying the label organized crime to the stereotypical groups (Type I), let alone the diversity of individuals and groups (Type II) that may facilitate or collude in securities-related misconduct and crime. The information reviewed shows that individuals who violate the *Criminal Code* are typically charged with fraud.

The securities sector plays a key role in Canada's financial services industry and economy. The total market capitalization in 2010 amounted to $2.3 trillion or 4 per cent of total trading among the world stock exchanges. While the 2011 Supreme Court of Canada decision rejected the federal government move towards a national securities regulator, the sector is a complex and de-centralized model of provincial regulation and cooperative national harmonization of key features. In addition, 'national' self-regulatory organizations (SROs) that receive their mandate through provincial legislation play a critical role to regulate the member firms and their employees.

The securities sector is vulnerable to organized crime for several reasons, not least that this is a hybrid zone with a focus on regulatory approaches and difficulties in applying crime labels. Potential wrong-doing can be difficult to identify and the interpretation of motivations and behaviour is not as clear as in other fields, such as interpersonal crimes. The securities sector is an area of low visibility that requires proactive enforcement and prevention, in part because victims may tend not to complain due to embarrassment or lack of knowledge, and industry participants may not want to report rule violations that would undermine confidence in their business.

Organized crime involvement in capital market offences is possible at several levels in terms of the depth of its infiltration of the securities market. The securities sector may be a site for the laundering of proceeds of crime generated outside of the industry, for instance, drug money, or a site for fraud and related laundering of proceeds generated to varying degrees within or alongside the sector. Criminal organizations can establish real or paper-based companies and sell real or fictitious stocks outside the regulated market, or attempt to secure the cooperation of industry insiders through the threat of violence or in repayment of gambling debts. It is also possible that criminal organizations or their members may establish partial or direct beneficial ownership of brokerage houses and engage a broader and deeper exploitation of victims. Some schemes that occur in Canada include fraudulent high-yield investments, pyramid or Ponzi schemes, and illicit

'tax-free' investments. The 20 (N=20) interviewees expressed particular concerns about Canadian investor involvement with boiler-room operations and the regulatory light-touch segments of international markets such as pink sheets and Over-the-Counter Bulletin Board (OTCBB) in the United States, the Frankfurt Stock Exchange (FSE) in Germany, and domestic markets, such as exempt securities.

Fundamentally, vulnerability is represented in the asymmetry between investors and (potentially fraudulent) market actors within or outside of the securities sector. The imbalance of information, knowledge and control in favour of market actors can be reduced through the scope and intensity of regulatory oversight. However, this can also result in push and pull factors for fraudulent behaviour to capitalize on variable standards across jurisdictions and national boundaries. Vulnerability is also a product of the convergence in the securities sector of a wide range of complementary and competing government, regulatory, industry and business, and investor interests. The essential profit-driven logic underlying commercial crimes is an apparently voluntary trade in (typically) legal goods and services combined with illegal (fraudulent) methods to manipulate market values to the disadvantage of victims. Enforcement data presented by regulatory authorities and the SROs illustrate their attempts to address these vulnerabilities. The volume of criminal charges in the securities sector remains limited in number but substantial in terms of estimated losses.

Reducing the vulnerability to crime and organized crime in the securities sector can be achieved through systematic attention to the limitations and possibilities of market forces and control systems. There is an ongoing need for basic and enhanced public education for investors to better protect themselves and to promote a culture of lawful and ethical behavior. Control agencies should function as interdependent (rather than strictly independent) agents within a clear set of defined goals and a coordinated strategy is necessary to detect and deter violations and to reduce impact and harm by issuing proportionate sanctions. Stakeholders could consider research and policy development in the design and implementation of a national data collection and securities intelligence model. This could improve the separate and cumulative detection and deterrence of serious repeat offending in Canadian capital markets, and its potential utility as a vehicle for criminals and organized crime.

Selected Legislation, Case Law, and Court References

Constitution Act, 1867

Criminal Code, R.S.C., 1985, c. C-46

La Reine c. Construction Exékut, 2011

Ontario Securities Act, R.S.O. 1990, C. S.5.

Proposed Canadian Securities Act, 2010

Québec Securities Act

Reference re Securities Act, 2011 SCC 66

Acronyms

AMEX	American Stock Exchange
AML	Anti-Money Laundering
ATF	Anti-Terrorist Financing
ATS	Alternative Trading Systems
AMF	Autorité des marchés financiers
BCSC	British Columbia Securities Commission
CFTC	U.S. Commodity Futures Trading Commission
CDIC	Canada Deposit Insurance Corporation
CAFC	Canadian Anti-Fraud Centre
CAPSA	Canadian Association for Pension Supervisory Authorities
CBA	Canadian Bankers Association
CCMA	Canadian Capital Markets Association
CDS	Canadian Depository for Securities Limited
CDCC	Canadian Derivatives Clearing Corporation
CIPF	Canadian Investor Protection Fund
CNSX	Canadian National Stock Exchange
CPAB	Canadian Public Accountability Board
CSA	Canadian Securities Administrators
CSI	Canadian Securities Institute
CSRA	Canadian Securities Regulatory Authority (Proposed Canadian Securities Act)
CTO	Cease Trade Order Database
CFSON	Centre for the Financial Services OmbudsNetwork
CSF	Chambre de la sécurité financière
CSG	Compliance Strategy Group
CISC	Criminal Intelligence Service Canada
Egmont	Egmont Group of Financial Intelligence Units
EFT	Electronic Funds Transfer
ESMA	European Securities and Markets Authority
EMDA	Exempt Market Dealers Association of Canada
FCAC	Financial Consumer Agency of Canada
FINRA	Financial Industry Regulatory Authority
FIU	Financial Intelligence Unit
FINTRAC	Financial Transactions and Reports Analysis Centre of Canada
FATF	Financial Action Task Force
FSE	Frankfurt Stock Exchange
GDP	Gross Domestic Product
ICE	ICE Futures Canada
IDA	Investment Dealers Association of Canada (2008 merged into IIROC)
IFIC	Investments Funds Institute of Canada
IMET	Integrated Market Enforcement Team, RCMP
IOSCO	International Organization of Securities Commissions
IIROC	Investment Industry Regulatory Organization of Canada
KYC	Know Your Client
LCTR	Large Cash Transaction

LSE	London Stock Exchange
MX	Montreal Exchange, Canadian Derivatives Exchange
MFDA	Mutual Fund Dealers Association of Canada
NASD	National Association of Securities Dealers (2008 merged into FINRA)
NASDAQ	National Association of Securities Dealers Automated Quotations
NGX	Natural Gas Exchange
NASAA	North American Securities Administrators Association
NYSE	New York Stock Exchange
NRD	National Registration Database
OBSI	Ombudsman for Banking Services and Investments
OSFI	Office of the Superintendent of Financial Institutions
OSC	Ontario Securities Commission
OSA	Ontario Securities Act, R.S.O. 1990, C. S.5.
OTC	Over-The-Counter
OTCBB	Over-The-Counter Bulletin Board
OTCQX	Over-The-Counter Markets Inc.
OTCQB	Over-The-Counter Markets Inc.
OTC Pink	Over-The-Counter Markets Inc.
PPSC	Public Prosecution Service of Canada
PSC	Public Safety Canada
QSA	Québec Securities Act
RS	Market Regulation Services Inc. (2008 merged into IIROC)
RECOL	Reporting Economic Crime Online
RCMP	Royal Canadian Mounted Police
SEC	U.S. Securities and Exchange Commission
SRO	Self-Regulatory Organization
SAR	Suspicious Activity Report
STR	Suspicious Transaction Report
SEDI	System for Electronic Disclosure by Insiders
SEDAR	System for Electronic Document Analysis and Retrieval
TSX	Toronto Stock Exchange
TSX-V	TSX Venture Exchange
TMX	TMX Group Inc.
UN	United Nations
US	United States

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1. Background

There is a growing concern that certain sectors of the Canadian economy may be especially vulnerable to infiltration by organized crime. In certain parts of Canada, criminal organizations (as defined by the *Criminal Code*) may be active in the securities sector. For example, a major Canadian organized crime figure has been linked to stock-market fraud, insider trading and related money laundering in Canada and Italy, and news services in Canada have reported official views that securities exchanges across the country are in need of further study to examine their vulnerability (Murphy 2010).

We encourage (non-specialist and international) readers to consult the list of acronyms above and the glossary of terms posted by Invest Right, an initiative of the British Columbia Securities Commission (BCSC). Securities are broadly categorized into debt and equity securities. Debt securities refer to monies borrowed with the promise to repay lenders at a specified time and interest rate. These include bonds issued and secured by governments via deposit insurance or against their credit rating and reputation to honour debt obligations, and debentures secured against the credit of the company borrowing the money. In simple form, equities refer to the exchange of money to obtain shares and stocks in a given company, and the investment is not subject to deposit insurance. The purchaser holds partial ownership in the company and he/she can trade this asset as its value rises or falls on the market and may receive scheduled payments (dividends) while retaining ownership. More complex securities products such as derivatives refer to rights to buy and sell specified component values or an index value of an underlying asset, for instance the value of a given index for a stock, market, national interest rates, foreign exchange, and credit.

2. Objectives

The principal aims of this project are to perform a detailed and accessible study of the securities sector within two Canadian jurisdictions, with a specific focus on the prevalence of, and vulnerability to, infiltration by or the activities of organized crime. The two jurisdictions chosen were Toronto (Ontario) and Montreal (Québec), as these jurisdictions are home to the main Canadian stock and derivatives exchanges, respectively.

These objectives are addressed through a descriptive overview of the Canadian securities sector and the two selected jurisdictions, a literature review focusing on knowledge gained from the international community, and analysis of data from 20 (N=20) interviews and available criminal intelligence. These different levels of data and analyses are then combined to elaborate a profile to identify general and particular vulnerabilities in the securities sector. The reader is then provided with conclusions based on the study findings and suggestions that could be considered to improve research and knowledge in this field and potentially increase resistance to organized crime in the securities sector. Please refer to the methodology (Appendix A) where we provide some discussion of our approach to using the method for assessing the vulnerability of sectors, MAVUS (Vander Beken 2005; Vander Beken et al. 2005), as applicable to the Canadian context and the topic of study.

3. Defining Organized Crime

There has been a lengthy debate about the definition of organized crime in both the research literature and in the law-enforcement and policy domain, and the reader may refer to various sources for detailed discussion (Albanese 2007; Beare, 1996; Cressey 1969; von Lampe 2008; Reuter 1983; United States' General Accounting Office 1977; Savona et al, 2011; Sheptycki 2007; Wortley 2010). Two aspects of the definitional debate are pertinent in an analysis of organized criminality and the securities sector: (1) the different associations in the representations of structured mafia groups (boss, underboss, captain, soldier, etc.) and the loose network structure of disorganized crime, and (2) the different activities that (with some uncertainty) are said to comprise organized, white-collar and corporate crime.

The mafia is portrayed in the alleged hierarchical structure and pervasive spread of the Cosa Nostra (Cressey 1969) as popularized in the *Godfather* films and other media representations. The disorganized crime model (Reuter 1983) proposes a fluid model of smaller networks and shifting alliances (which may or may not involve larger groups) that are as organized as is necessary and sufficient to undertake specific criminal operations. Some argue that it is important to separate certain crimes from organized crime, whereas others argue that white-collar and corporate crime, corruption and other related crimes are not analytically separable from organized crime (Ruggiero 1996).

At a practical and policy level, these debates have largely concluded with the introduction of the 2000 United Nations Convention Against Transnational Organized Crime (also known as the Palermo Convention), and the implementation of the Palermo Convention definitions and provisions within national legislation. Section 467.1 of the *Criminal Code* does not define organized crime but employs the proxy phrase, criminal organization that refers to a group, however organized, that:

> (a) is composed of three or more persons in or outside Canada; and
> (b) has as one of its main purposes or main activities the facilitation or commission of one or more serious offences [indictable offences with 5 or more years imprisonment as the maximum penalty or offences prescribed by regulation] that, if committed, would likely result in the direct or indirect receipt of a material benefit, including a financial benefit, by the group or by any of the persons who constitute the group.

While this definition excludes groups that form randomly for the immediate commission of a single offence, additional sections prohibit participation in, the commission of an indictable offence for, and instructing the commission of an offence for, a criminal organization.

These definitions are supplemented by the criminalization of money laundering in section 462.31(1):

> Every one commits an offence who uses, transfers the possession of, sends or delivers to any person or place, transports, transmits, alters, disposes of or otherwise deals with, in any manner and by any means, any property or any proceeds of any property with intent to conceal or convert that property or those proceeds, knowing or believing that all or a

part of that property or of those proceeds was obtained or derived directly or indirectly as a result of

(a) the commission in Canada of a designated offence; or
(b) an act or omission anywhere that, if it had occurred in Canada, would have constituted a designated offence.

The concept designated offence refers to serious or indictable offences under any Act of Parliament other than an indictable offence prescribed by regulation, or it may include a conspiracy, attempt, being an accessory after the fact or counselling in relation to such indictable offences. The international benchmark is to criminalize virtually any interaction with, or disposition of, the proceeds of crime regardless of whether it involves those participating in the underlying (predicate) offending or any other parties (Hicks 2010; Hicks and Graycar 2011). The Canadian definition is largely consistent with the prevailing international standard with the exception of the phrase 'knowing or believing.' This adds a specific mental intent element that may limit the liberal application of money laundering prosecutions, and this may not be consistent with international convention (Financial Action Task Force 2008).

Criminal organization and money laundering definitions make it clear that, at a legal level, the understanding of the concept organized crime has shifted. The goal has turned towards investigation and assessment of serious patterns of criminal association and activities. This focuses our inquiries onto groups involved in serious offences for direct or indirect material benefit, those who support such groups, and those who knowingly interact with or engage in any disposition of the proceeds of crime. Clearly, the term criminal organization is no longer restricted to those groups with enduring hierarchies or strictly delineated roles. It now encompasses almost any repeated (i.e., non-random activity or association) criminal offences or conspiracies involving three or more co-offenders.

For instance, Wortley (2010) has proposed a tri-partite model in an effort to promote more systematic understanding and classification of street gangs as organized crime. Level one would include fluid groups involved in spontaneous criminal activity, level two would include a largely informal structure but ongoing and deliberate criminal activities over a year or more, and level three would include a hierarchical organizational structure with identifiable leaders and aiming to control one or more criminal activities in a geographic region. The first level may not generally meet the *Criminal Code* definition, and poses a different set of risks as compared with more structured groups.

Savona et al., (2011) note that a number of authors suggest the concept of organized crime should be replaced, or at least complemented, with other concepts such as criminal enterprise and profit-driven crime. Naylor (2003) helps to clarify the economic logic behind profit-driven crimes with a tri-partite model: predatory, market-based and commercial. Predatory crimes such as robbery are 'purely transferral' given the involuntary nature of bilateral property extraction from victims. Market-based crimes such as the illicit drug trade are 'partly functional' given the (more or less) voluntary nature of multilateral exchange for illicit goods or services. Commercial crimes such as fraud in the securities market are apparently voluntary, given the

multilateral trade in legal goods and services, but also involuntary, given the illegal (fraudulent) methods of manipulating market values to the disadvantage of victims.

This clarification of the economic logic underlying profit-driven crimes points us toward the meaning of vulnerability affecting the securities sector (See Appendix A). Fundamentally, vulnerability is represented in the asymmetry between investors and (potentially fraudulent) market actors within or outside of the securities sector. The scope and intensity of regulatory oversight, both in terms of static rules on listing and reporting requirements as well as dynamic market surveillance, can reduce the imbalance of information, knowledge and control. Nevertheless, regulatory oversight could itself be a potential source of vulnerability where there are variable standards with respect to the rules and regulations within and between jurisdictions and across national boundaries. More generally, vulnerability is also a product of the convergence in the securities sector of a wide range of complementary and competing interests. Governments at all levels, industry participants and regulators, businesses, communities, and individuals have a vested interest in the smooth flow and functioning of the securities sector.

Given the fundamental, regulatory, and structural asymmetries, readers should appreciate that it would be unwise to focus solely on the infiltrating 'other' to the neglect of the facilitating 'self.' Organized crime may well be a parasitic form that infiltrates and bleeds the securities sector, but it may also be a symbiotic form where otherwise legal elements of the sector (knowingly, unwittingly or through willful blindness) facilitate or collude in misconduct and crime (Diih 2005).

The available data on crime and organized crime affecting the Canadian securities sector is limited and modest, and it is hoped that this paper will contribute to the foundations of a more comprehensive and mature state of knowledge for further analysis. This work will rely on what crime and organized crime is, and what those involved in such activities do, but we appreciate the difficulty of speculating given the current limited evidence available on who or what groups are involved. Law-enforcement colleagues and others will note, however, that the lack of or limited evidence of a given phenomenon does not offer proof of its non-existence as an issue.

Given the nature and scope of data on crime and organized crime within the securities sector in Canada that we explore below, we will employ a distinction in this paper between two views of organized crime, for conceptual clarity:

- Type I: the 'common-sense' understanding of organized crime as traditional Italian or Mafia organizations, outlaw motorcycle gangs (OMGs) and other groups involved in extortion, illicit drugs and other serious offences.
- Type II: the 'nominal understanding' of organized crime as any repeated serious criminal offences or conspiracies involving three or more co-offenders that may involve a diversity of forms of association or categories of serious offences.

This project reveals that many individuals and groups tend to implicitly or explicitly treat Type I as 'real' organized crime and to limit the application of this label to Type II. The differential treatment is persistent despite the section 467.1 expansive definition enacted into the *Criminal Code* in 2002. As we explore below, the reasons behind this limited application contribute

towards an understanding of the known and unknown vulnerabilities to organized crime that may affect the securities sector in Canada.

4. The Canadian Securities Sector

This section of the paper offers readers a meso-level analysis of selected aspects of the Canadian securities sector. We provide a review of the division of powers under the constitution and selected statistics on the key role of the securities industry in Canada. Readers are then provided with information on the intake, investigation, and prosecution process as well as a national legal, regulatory and statistical overview of securities-related violations and offences. We then turn to the legal and regulatory framework for Ontario and Québec, which is followed by a discussion of the role of 'national' self-regulatory organizations (SROs). Finally, we discuss *Criminal Code* investigations, and provide some conclusions based on the findings in this section. Throughout the section we focus on a number of inter-related issues associated with data collection, what we know and do not know about vulnerabilities to crime and organized crime, and what this may mean in terms of national data collection and the management of systemic risk.

4.1 Constitutional Powers and the Key Role of the Securities Industry

Understanding the complex nature of the Canadian securities sector, and information sources about it, requires an appreciation of the *Constitution Act, 1867*which, among other objectives, specifies the distribution of powers such as the federal and provincial authority to legislate. The Parliament of Canada has the authority to issue criminal legislation under s. 91(27), and to regulate trade and commerce under s. 91(2). The provinces are delegated with powers addressing the administration of civil and criminal justice under s. 92(14), which includes policing, prosecution and courts, and the provinces additionally have legislative authority over property and civil rights under s. 92(13). This very selective review of sections of the Canadian constitution is provided to make the following distinction clear for readers:

- Federal legislative authority allows for the *Criminal Code*, and amendments, and the regulation of trade and commerce where it is of interprovincial and national importance.
- Provincial legislative authority allows for the administration of civil and criminal justice systems, and the regulation of property and civil rights such as the securities market.

The federal government is therefore responsible for legislation addressing criminal offences affecting the securities market in Canada, and also for systemic risk and potential impact that is of regional or national importance. The provinces are responsible for legislation concerning regulation and quasi-criminal offences in the securities market in their respective jurisdictions, and have the right of first refusal on criminal prosecutions within their jurisdiction. That is, the provinces have the option to refer criminal cases to the relevant federal agency for criminal prosecution by the Public Prosecution Service of Canada (PPSC).

There can be little dispute that the securities sector plays a key role in the financial services industry and economy of Canada. It enables Government and business to raise equity capital and debt, to attract foreign direct investment, and it allows investors to trade in capital markets both within Canada and beyond its borders.

According to the World Federation of Exchanges (See Table 4.1.0, Appendix B), the combined market capitalization for all exchanges is equivalent to $56.822 trillion USD that can be subdivided into the following volumes and rounded percentage of the total in parentheses:

- NYSE Euronext (US) $13.394 trillion USD (24 per cent)
- NASDAQ QMX $3.889 trillion USD (7 per cent)
- London SE Group was $3.613 trillion USD (6 per cent)
- TSX Group $2.170 trillion USD (4 per cent)

The TMX Group is the eighth largest exchange group of market capitalization in the world. Operating in Canada's major financial centres, the TMX Group owns the Toronto Stock Exchange (TSX), the TSX Venture Exchange (TSX-V), and the Montreal Exchange (MX) that is the main national derivatives trading facility as well as owning other exchanges, trading and investor companies. The structure of the Canadian capital market involves the trading of two products in the securities industry. First are fixed-income securities products which include bonds, asset-backed securities and money-market instruments traded in dealer markets. Second are equity products, which include common and preferred shares, and are mostly traded on stock exchanges.

In terms of national performance, during the month of January 2011, securities, commodity contracts and other financial vehicles accounted for over $11.7 billion (nearly 1 per cent) of the total Canadian Gross Domestic Product or GDP at $1.26 trillion (Statistics Canada, 2011b). Non-resident investors purchased a further $13.3 billion of domestic securities and residents purchased $2.0 billion of foreign securities during the month of January 2011 (Statistics Canada, 2011a). According to the Alberta Securities Commission (2011) and illustrated in Figure 4.1.0 in Appendix C, the distribution of market capitalization and relative percentage is as follows: Ontario $915 billion (40 per cent), Alberta $573 billion (25 per cent), British Columbia $276 billion (12 per cent), and Québec $227 billion (10 per cent).

While the volume of such assets relative to GDP may seem modest, the accumulated volume of securities can be considerable. For instance, Canadian investors held $585.6 billion in foreign securities with some of the largest volume occurring in the United States (55 per cent), the United Kingdom (8 per cent), Japan (6 per cent), France (4 per cent) and Germany (less than 4 per cent) (Statistics Canada, 2010). Additionally, the aggregate market value of all Canadian share issues is equivalent to $1.84 trillion, and the Canadian securities industry comprises 2,121 firms and 121,841 individuals on the National Registration Database (Canadian Securities Administrators 2010).

The sheer size and volume of the industry and its cross-cutting economic importance, within and beyond the country, makes the securities sector a focal point for many interests including those of different levels of government. On May 26, 2010, the Government of Canada released a proposed Canadian *Securities Act* and concurrently referred it to the Supreme Court of Canada for its opinion on whether the proposed act is "within the legislative authority of the Parliament of Canada." The proposed legislation would create a Canadian Securities Regulatory Authority (CSRA) along with a voluntary national regime to which provincial regulators would have the opportunity to opt-in (Finance Canada 2010). It appears that Canada is the only major

industrialized country without a national-securities regulator. It was hoped that the proposed legislation would address many of the critiques and problems associated with a de-centralized securities regulatory system that have been raised by market participants, institutional and retail investors, academics and international agencies (Cf. Cory and Pilkington 2006; LePan 2007; Public Safety Canada 2010).

The Supreme Court of Canada (2011) found that the proposed Canadian *Securities Act* is not valid under the general branch of the federal power to regulate trade and commerce because it does not limit itself to "matters of genuine national importance and scope" such as the management of systemic risk and national data collection. The court re-affirmed the powers of provincial legislatures in the regulation of the securities market within their respective jurisdiction. The court left open the possibility of a cooperative approach recognizing the "essentially provincial nature of securities regulation" and the role of the Parliament of Canada "to deal with genuinely national concerns" and that this remains a constitutional and available option for the parties.

The reader will find below a number of inter-related issues associated with national data collection and, potentially, the management of systemic risk in the securities sector.

4.2 Legal, Regulatory, and Statistical Overview for Canada

The Canadian Securities Administrators offers a helpful overview (CSA 2010:30) of the securities regulatory and enforcement process in Canada that is outlined below and used as a reference point for the discussion that follows:

- Information Sources: Contraventions may be revealed by internal sources such as compliance and surveillance activities or external sources such as public or market complaints

- Case Assessment: Issues are assessed for seriousness and referral to:
  - Self-Regulatory Organizations (SROs)
  - Investigation into facts and evidence to prepare for litigation and to seek interim cease-trade, freeze or reciprocal orders
  - Municipal, provincial or federal law enforcement for evidence of criminal activity

- Litigation: A contravention may be brought before one of two bodies:
  - Administrative Tribunals (securities commission, regulatory authority) may impose sanctions and orders following a negotiated settlement or contested hearing
  - Provincial Courts may imposes fines and/or prison following a trial or guilty plea for securities law and related offences

The CSA (2010) is a voluntary umbrella organization of the 13 securities regulators that aims to coordinate and harmonize regulation of the Canadian capital markets through domestic and international activities. Its mission is to give Canada a securities regulatory system that protects investors from fraudulent, manipulative or misleading practices, and to ensure investors have fair

access to market or price information, and to reduce the risk of failure of market intermediaries. One example of efforts to coordinate was the 2004 Memorandum of Understanding that created a securities passport system where a decision from one regulator automatically applies to other jurisdictions in Canada under harmonized laws. The one exception is Ontario which offers an interface system in which its regulator makes its own decisions, but these generally rely on the decision of the originating Canadian regulator.

The CSA provides a variety of services such as online facilities for national registration searches with certain exceptions, such as the separate Ontario system. Such facilities also include a National Registration Database (NRD), which was launched in 2003 as an initiative of the CSA and the IIROC to provide a central portal for enrolled dealers and advisers to submit applications and notices to Canadian securities regulators. Readers may refer to the list of acronyms above for the Internet links to these online facilities. Members of the CSA also participate in regional and international initiatives such as the International Organization of Securities Commissions (IOSCO) to promote information exchange, mutual assistance, effective surveillance of international transactions, and cooperation in fostering efficient and well-regulated securities markets.

An effectively national overview of regulatory and other violations in the securities sector is available in the combined cases addressed by CSA members (Table 4.4.1). This includes information on the number of cases, and the associated fines, administrative penalties, restitution, compensation and disgorgement.

It is clear that illegal distributions, that is the sale of securities by unregistered dealers, continues as a key problem area accounting for one-half to two-thirds of cases in the reported data. Misconduct committed by registrants is a distant second category accounting for over one-fifth to nearly one-quarter of the cases in the reported data. The unit of analysis for the data is the case, which is counted once, even though the 178 proceedings in 2010 involved 301 individuals and 183 companies. The manner in which the 2010 cases were concluded was 41per cent by settlement agreement, 37 per cent by court proceeding, and 22 per cent by contested hearing. In addition to regulatory sanctions and monetary penalties issued in 2010, provincial courts in four jurisdictions ordered jail terms ranging from three months to three years for 15 individuals. In 2010, CSA members also imposed 41 interim orders and asset freezes, 98 individuals and 89 companies were placed under trading restrictions, the bank accounts of 13 individuals along with 14 companies and four trusts were frozen, and 74 reciprocal orders were issued to prevent sanctioned individuals and companies from trading in other jurisdictions.

Table 4.4.1: Regulatory/Criminal Securities Cases Across Canada

	2008	2009	2010
Illegal Distributions	65 [a] $8,411,500 [b] $15,839,708 [c]	68 [a] $30,833,925 [b] $21,131,933 [c]	115 [a] $53,592,614 [b] $57,000,617 [c]
Misconduct by Registrants	30 [a] $368,304 [b] $697,529 [c]	29 [a] $106,186,510 [b] $1,280,695 [c]	21 [a] $4,971,418 [b] $1,554,866 [c]
Illegal Insider Trading	8 [a] $1,203,013 [b] – [c]	16 [a] $1,769,744 [b] $1,675,056 [c]	13 [a] $1,835,974 [b] – [c]
Disclosure Violations	11 [a] $1,947,300 [b] – [c]	14 [a] $14,454,329 [b] $68,100,000 [c]	11 [a] $3,148,500 [b] – [c]
Market Manipulation	4 [a] $460,000 [b] – [c]	3 [a] $3,000 [b] $18,641 [c]	4 [a] $56,000 [b] – [c]
Miscellaneous	5 [a] $79,000 [b] – [c]	11 [a] $425,500 [b] – [c]	10 [a] $222,500 [b] – [c]
Total	123 [a] $12,469,117 [b] $16,537,237 [c]	141 [a] $153,673,008 [b] $92,206,325 [c]	174 [a] $63,827,006 [b] $58,555,483 [c]

a = concluded cases
b = fines and administrative penalties
c = restitution, compensation, and disgorgement

Source: (CSA, 2010)

In an industry of 2,121 firms and 121,841 individuals, a rough calculation shows that 0.0025 or two-and-a-half tenths of one percent of registered individuals (i.e., 301 ÷ 121,841) and 0.086 or 8.6 per cent (i.e., 183 ÷ 2,121) of registered firms were a party to concluded cases in 2010. Given that individuals are subject to the most severe potential penalties such as imprisonment, a minor proportion of the less than three tenths of one per cent of registered individuals associated with concluded cases may connect to the more serious and repeat examples of offending in the securities market. This number seems decidedly low given the scope of financial temptation in the securities market. This may reflect the quality and intensity of regulation and/or generally professional conduct within the securities sector. The question of regulatory capacity to detect and deter serious and repeat offending in Canada's capital markets remains open. Indeed, there are a number of frauds such as boiler-rooms where offenders would find little need or incentive to register themselves on the National Registration Database.

4.3 The Legal and Regulatory Framework in Ontario and Québec

Provincial legislation allows for the *Securities Act*, which provides the legal foundation for securities commissions and associated regulatory requirements related to capital markets as well as regulating (e.g., licensing) issuers and registrants under the Act. Provincial securities legislation has in common the objectives of protecting investors and ensuring a fair, efficient, and transparent capital market. The provincial regulators also share the common core

responsibilities for prospectus review, continuous disclosure, and regulation of traders, enforcement and public education.

The provincial securities commissions have no authority to order a term of imprisonment, but can pursue quasi-criminal offences established under the relevant securities legislation. In some jurisdictions, staff may directly prosecute cases in courts or, in other cases, securities regulators may refer allegations of certain quasi-criminal offences to the Crown attorney for prosecution. In other cases, the securities regulators may bring allegations of securities misconduct to a hearing before an administrative tribunal, which could be under a securities commission or a self-regulatory organization (SRO). The SROs, discussed in greater detail below, are private organizations to which provincial securities regulators have delegated the authority to devise and enforce rules for the conduct of association members. Securities legislation authorizes the relevant tribunal to impose or seek administrative sanctions for securities-related misconduct. These administrative sanctions may include supervision, discipline, fines and suspension or revocation of licenses to trade, and monetary penalties such as fines, covering the costs of investigations and (directly or indirectly) re-paying losses to investors. Alternatively, securities-law violation cases may be referred to provincial courts that may impose various sanctions, such as fines and imprisonment.

Ontario is the largest capital market in Canada. The Toronto Stock Exchange is the 3rd largest in North America and the 8th largest in the world by total listed-company market capitalization. The regulatory body responsible for overseeing capital markets in the province is the Ontario Securities Commission (OSC). The commission administers and enforces the provincial Securities Act, the provincial Commodity Futures Act, and administers provisions of the provincial Business Corporations Act. It also provides material information and documents filed by public companies. The OSC is also responsible for registering individuals and firms in the business of trading securities, managing investment funds, and chief compliance officers for all firms.

Additionally, the OSC regulates exchanges, alternative trading systems, quotation and trade reporting systems, and investment funds, including mutual funds, exchange-traded funds, labour-sponsored investment funds, scholarship plans, and commodity pools. The OSC is responsible for the Toronto Stock Exchange, the Canadian National Stock Exchange, as well as other trading equities, debt and derivatives (e.g., Omega Securities Inc, ICE Futures Canada Inc, Natural Gas Exchange Inc).

Under the Ontario *Securities Act*, the IIROC is recognized as a self-regulatory organization that oversees all investment dealers as well as trading activity on debt and equity marketplaces in Canada. The IIROC also provides compliance/surveillance and enforces rules and regulations regarding sales, members and market compliance (business conduct, financial compliance and Trade review and analysis) and market surveillance. The IIROC also issues Universal Market Integrity Rules and Policies (UMIR) which provides a set of equities-trading rules designed to ensure fairness and maintain investor confidence. These rules state: "A Participant shall diligently pursue the execution of each client order on the most advantageous execution terms reasonably available under the circumstances." The rule goes on to state that brokers should

consider the following factors when executing orders: price at which the trade would occur, speed of execution, certainty of execution; and overall cost of the transaction (IIROC, 2010b).

The OSC also carries out various compliance reviews, inspections, investigations and prosecution of those individuals, dealers and companies that violate securities law and regulations in Ontario. In 2010, the OSC carried out 35 enforcement activities involving 108 individuals and 69 companies. Twenty-seven proceedings were concluded involving 29 companies and 45 individuals. According to the OSC enforcement activities report, these enforcement proceedings resulted in monetary sanctions and fines for costs of $53,477,972. In two cases, the courts imposed jail terms.

Furthermore, anyone selling securities, offering investment advice or managing a mutual fund in Ontario must register (and consequently be licensed) with the OSC. A person registered with the OSC is also required to be a member of a self-regulatory organization such as the IIROC or the MFDA. The MFDA is formally recognized as a self-regulatory organization by the provincial securities commissions in British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, Nova Scotia, and New Brunswick. An application for recognition is pending in Newfoundland and Labrador, and the MFDA has entered into a co-operative agreement with the Autorité des Marchés Financiers and actively participates in the regulation of mutual-fund dealers in Québec. A firm registered as an investment dealer must be a member of the IIROC.

A firm registered as a mutual-fund dealer must be a member of the MFDA. The MFDA is responsible for mandating, monitoring compliance with, and enforcing common rules and practices related to mutual funds. The MFDA has also established the Investor Protection Corporation (IPC), a not-for-profit corporation. Under the IPC, the MFDA administers an investor-protection fund for the benefit of clients of mutual-fund dealers that are members of the MFDA. The fund protects client assets held by a member firm in the event that the member firm becomes insolvent (MFDAIPC 2010).

These self-regulatory organizations provide training and continuing-education programs for those individuals registered with these organizations. The self-regulatory organizations also provide minimum capital requirements for firms, conduct surprise on-site audits, and require comprehensive financial reporting. The self-regulatory organizations additionally have the power to establish and enforce industry regulations to protect consumers and to ensure companies conduct their business in a fair and ethical manner.

A capital market of this size also includes a substantial labour force. Table 4.2.1 gives an overview of the number of individuals working in this market, including the number of firms. The table shows that in 2009-2010, approximately 67,000 individuals were registered, and 3,159 were working as investment-fund issuers. The table also shows that there are roughly 1,400 public trading companies and a similar number of registered firms.

Table 4.2.1: Number of Public Companies, Individuals and Firms Registered with OSC for the Years 2007-2010

	2007-2008	2008-2009	2009-2010
Public Companies	1,466	1,482	1,429
Investment Fund Issuers	3,066	3,169	3,159
Registered Firms	1,700	1,721	1,424†
Registered Individuals	68,605	70,057	64,637†

Source: (OSC, 2010)

The securities and derivatives market is regulated in the province of Québec by the Autorité des marchés financiers (AMF). The Autorité des Marchés Financiers du Québec has delegated authority to register individual employees and agents only. Similar to Ontario and all the other regions, the IIROC is recognized as a self-regulatory organization and therefore carries out its regulatory responsibilities through setting and enforcing rules regarding the proficiency, business and financial conduct of dealer firms and their registered employees operating in Québec. Individuals and firms working in mutual funds are members of the MFDA and, as noted above, the MFDA has entered into a co-operative agreement with the Autorité des Marchés Financier to actively participate in the regulation of mutual-fund dealers in Québec.

In addition to the AMF being responsible for the securities legislation, they are also responsible for administering other Acts applying to automobile insurance, deposit insurance, the insurance industry, financial-services cooperatives, the distribution of financial products and services, compensation for the executives of the AMF, Mouvement Desjardins and trust and savings companies. Under a memorandum of understanding, the AMF shares anti-money laundering (AML) compliance responsibilities (to avoid duplication) and related data sharing with the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC) on their relevant areas of jurisdiction.

The number of people working in the securities sector is also substantial. Table 4.3.1 shows that in 2009-2010, 32,995 individuals were working as unrestricted practice broker firms, 5,416 were working as reporting issuers, and 1,488 were providing advice. These representatives worked for 371 dealers and 381 companies registered as securities advisors.

The Direction générale du contrôle des marches et des affaires juridiques is responsible for the investigations, monitoring, inspections and compliance of the laws under the AMF. The Chambre de la sécurité financière (CSF) is the provincial self-regulatory organization (SRO). The CSF ensures that financial sector professionals operate in the interest of consumers by offering them products and services that protect and stimulate the growth of their family assets and can proceed against those who break industry rules. The CSF also promotes the ongoing development of the skills of financial sector professionals in Québec. Table 4.3.2 gives an overview of the number of files being inspected (the AMF gives a global view but does not break out securities-related inspections). The data show that over the years 2003-2010, there is

variation regarding the type of inspection activities carried out. There may be several reasons for this variation, including the availability of qualified staff to conduct the inspections.

Table 4.3.1: Number of Dealers and Representatives Registered with Autorité des marchés financiers for the Years 2007-2010

	2007-2008	2008-2009	2009-2010
Securities			
Reporting issuers	5,509	5,503	5,416
Unrestricted practice brokerage			
Dealers	146	146	371
Representatives	32,692	32,829	32,995
Securities Advisors			
Advisors	245	262	381
Representatives	1,180	1,299	1,488

Source: (AMF, 2010)

Table 4.3.2: The number of Inspection Files Regarding Infractions under the Securities Legislation

	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10‡
Opened	7	77	22	10	3	14	62
Completed	2	99	31	22	10	8	48
Pending	59	34	25	10	3	9	32

‡This increase is attributed to changes in the provincial regulations that required a review of other files related to insurance.

Source: (AMF, 2010)

4.4 'National' Self-Regulatory Organizations (SROs)

In this sub-section, we focus on two self-regulatory organizations, the Investment Industry Regulatory Organization of Canada (IIROC) and the Mutual Fund Dealers Association of Canada (MFDA). The word national is placed in single quotations above because the mandate and authority of the IIROC and MFDA (while it does cut across provincial boundaries) is largely derived from provincial securities legislation and in cooperation with the provincial securities regulatory authority and industry stakeholders.

The Investment Industry Regulatory Organization of Canada (IIROC 2010a) is a national SRO created in 2008 through the merger of the Investment Dealers Association of Canada (IDA) and Market Regulation Services Inc. (RS). The IIROC oversees all debt and equity marketplaces in Canada with respect to investment dealers and trading activity. This includes elaborating regulatory and industry standards, character and educational achievement screening of all investment advisors in regulated firms, conducting financial and business compliance reviews, market surveillance, and the investigation of complaints and taking disciplinary action when rules are broken. The IIROC oversees some 212 dealer-broker firms, including those associated with the major banks and a variety of additional firms across Canada. The IIROC oversight capacity is considerable and includes registration and qualification of broker-dealers and firms, various compliance requirements including anti-money laundering, and the application of real-time monitoring and capability to reverse trades that violate market integrity rules.

Table 4.4.2: IIROC Violations Type in Enforcement Actions for Individuals and Firms for the Year 2009-2010

Type of violations	Number
Individuals	
Inappropriate personal financial dealings	15
Gatekeeper	13
Handling of client accounts	13
Theft, fraud or misrepresentation	12
Supervision	8
Suitability	6
Undisclosed conflict of interest	6
Off-book transactions	5
Failure to cooperate	5
Trading without a prospectus or exemption	3
Trading without appropriate registration	3
Improper disclosure of client's information	2
Insider trading	1
Renewal of promissory notes without notice	1
Total	91
Firms	
Supervision	4
Inadequate books & records	3
Failed to respond to emerging issues	1
Capital deficiency	1
Total	11

Source: (IIROC, 2010a)

The Table 4.4.2 illustrates that inappropriate personal financial dealings, gatekeeper functions, handling of clients' accounts, and theft, fraud or misrepresentation are the main violations by individuals under IIROC terms and conditions. For firms, supervision and inadequate books appear to be the key problem areas. Upon reviewing these violations, it is not apparent whether any were associated with a criminal organization, as defined in the *Criminal Code*.

In addition to the enforcement actions above, IIROC has responded to 480 complaints on the marketplace, 429 complaints against dealer firms, handed out disciplinary proceedings against firms (8) and individuals (37), assessed $35.3 million in fines against firms and individuals,

suspended two firms, 12 individuals and permanently banned 13 individuals from working in the capital markets (IIROC, 2010a).

The Mutual Fund Dealers Association of Canada (MFDA, 2010) is another national SRO established in 1998 to regulate the operations, standards of practice and business conduct of its members and representatives who are mutual-fund dealers licensed by provincial securities commissions in seven Canadian provinces, including Ontario. The MFDA actively participates in the regulation of mutual-fund dealers in Québec through a co-operative agreement with the provincial regulator, the Autorité des marchés financiers (AMF). As of September 2010, the MFDA had 138 members who sponsor approximately 73,456 mutual-fund salespersons and represent $287.4 billion in administered mutual-fund assets. Regulated firms include those associated with the major banks and a diversity of other such firms across Canada.

Table 4.4.3: MFDA Cases Opened by Type July 1, 2009- June 30, 2010

Type of violations	Number
Falsification / Misrepresentation	74
Suitability – Investments	57
Unauthorized / Discretionary Trading	50
Suitability - Leveraging	44
Outside Business Activities / Dual Occupation	31
Personal Financial Dealings	28
Forgery / Fraud / Theft / Misappropriation / Misapplication	24
Supervision	24
Business Standards	24
Policy & Procedures	20
Complaint Procedure	19
Transfer of Accounts	16
Sales Communication	15
Commissions and Fees	10
Conflict of Interest	7
Conduct Unbecoming	6
Acting Outside Registration Status	5
Trading Outside Jurisdiction	5
Referral Arrangements	5
Handling of Funds	5
Other (aggregate of categories)	37
Total	506

Source: (MFDA, 2010, 2011)

The Table 4.4.3 (and supplementary tables in Appendix B) illustrates the range of cases opened by the MFDA with respect to its members and approved persons for compliance violations. The main problem areas appear to be falsification/misrepresentation, the suitability of recommended investments, unauthorized/discretionary trading, suitability-leveraging, and involvement in outside business activities.

The MFDA data for 2009-2010 demonstrates that nearly 90 per cent of cases that are investigated do not progress beyond “no violation established” (38 per cent), or are violations of a minor nature that warranted a cautionary letter (31 per cent), or a warning letter (19 per cent). The net result was that MFDA staff commenced 26 disciplinary cases in the 2009-2010 fiscal year, a decline of five cases from the previous year, due to a court decision that was ultimately

resolved in favour of the SROs having jurisdiction over the relevant matters. We have appended the supplementary tables in Appendix B, given that the MFDA's current-year-of-enforcement statistics were not available in time for review in this report.

Readers will note similarities and differences in the categories of data collected and presented by the IIROC and MFDA, in the summary above and within their respective websites and publications. This presents clear difficulties in terms of comparative and more detailed analyses of the data. The current project did not include a mandate to review the operational data-collection processes of SROs or any other entities relevant to the study. We encourage readers to refer to the data presented above by the Canadian Securities Administrators (CSA) for a national overview of securities regulatory and enforcement data.

4.5 Criminal Code Offences

The *Criminal Code* prohibits, under the sections indicated below, a range of market and economic behaviour that can damage the interests of individual investors and the public perception of the securities sector. These include general applicable criminal-offence categories such as fraud 380.(1) and money laundering 462.31(1). These also include securities-specific offence categories such as: affecting a public-securities market through fraud or deceit 380.(2), manipulating transactions to give a misleading market value 382, and trading with insider information and tipping others to trade on insider information 382.1(1)(2). It is also a criminal offence to engage in gaming with respect to stocks or merchandise 383.(1), that is, to profit from the rise or fall in the price of a company stock by engaging in any verbal or written contract without the *bona fide* intention of acquiring or selling shares. The securities-specific provisions above are largely indictable offences with maximum punishments of imprisonment for 14 years (affecting a public market), 10 years (manipulating transactions and insider trading), and 5 years (tipping with insider information, an offence that may alternatively be prosecuted by summary conviction).

Cases involving criminal activity may be referred to the Royal Canadian Mounted Police (RCMP) and/or provincial or municipal police. The Government of Canada introduced the Integrated Market Enforcement Team (IMET) program in 2003 to counter threats to investor confidence and economic stability through the investigation and enforcement of securities-related criminal offences. Managed by the RCMP and Justice Canada, IMET offices are in place in major centres across Canada. This program integrates the efforts of relevant federal agencies and provides a direct point to liaise with relevant regulatory, investigative and prosecutorial bodies at the provincial level.

The IMETS investigations and prosecutions generally relate to the more serious cases of capital-market abuse, and thus the number of cases and individuals is modest compared with the regulatory-oriented data presented above. From 2003-04 through to May 2010, 30 individuals have been charged in 13 cases. Charges were mostly laid under section 380 (fraud) of the *Criminal Code*. Estimated losses associated with these cases are approximately $627.4 million. Criminal cases can take considerable time to process and most of the above cases are still before the courts, with the majority of the accused awaiting a preliminary hearing or trial. There have been only seven guilty pleas and one conviction. It should be acknowledged that IMETs can

also engage in non-criminal processing, such as accompanying securities-commission and SRO officials for preventive "knock and talk" sessions with market participants who are violating the rules (Public Safety Canada 2010). While there are a number of barriers to the successful execution of the mandate, Williams (2008) argues that IMETs are constrained at a fundamental level by their relative position within a broader regulatory field that presents a complex structure and politics.

In concluding this overview of key aspects of the Canadian securities sector, we would highlight some interrelated themes**.** First, the sector can be characterized as a diverse and complex structure of regulation and control**.** There has been a progressive movement towards greater national integration, while accepting the traditional oversight role of the provinces for capital markets that function in their jurisdiction. In other words, there are national approaches where necessary, but not necessarily a centrally controlled and harmonized approach. It is not clear whether the complexity of the Canadian situation provides an inducement (pull) or acts as a deterrent (push) for domestic or international organized crime. This could be a fruitful line of inquiry for further research.

Second, the data collected and made available represent the throughput (input and output) of the various organizations and their respective mandates**.** There does not appear to be any systematic approach to collect or present data on the relative severity of repeated securities offences involving three or more offenders (Type I or Type II) let alone the harm and losses suffered by victims**.** National data reveal that two-and-a-half tenths of one per cent of registered individuals were associated with the 174 concluded cases in 2010. The numbers involved in *Criminal Code* offences, despite the greater seriousness and some documentation of serious losses, represent an even smaller proportion of the volume. The various stakeholders could consider the development of a systematic national data collection and intelligence protocol such that combined data can be more than the sum of its parts.

Third, this national data collection and intelligence protocol could consider the inclusion of anti-money laundering (AML) compliance data collected by the relevant regulatory authorities and the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC). Money laundering is an inherent feature of capital-market offences. Nevertheless, it is striking that so little information is available to illustrate the use of AML data to provide strategic insights into serious repeat offending or tactical utility in investigations and prosecutions in securities-related offending (Cf. Brennan and Vaillancourt 2011; FINTRAC 2011; IIROC 2010c; RCMP 2011).

5. Organized Crime in the Securities Sector

This section of the report provides a macro-level environmental scan of relevant literature that can contribute towards insights into organized crime in the securities sector. It addresses the possible prevalence of organized crime in the sector, which is not possible to systematically assess because most of our knowledge is based on incidents that occur. While the literature provides some insights, there is an argument to be made for shifting our focus onto qualifying and quantifying harm to victims and the impact of countermeasures in reducing such harm. Attention then turns to why the securities sector is vulnerable to organized crime. The securities

sector is a hybrid zone of low visibility in which regulatory and criminal approaches are used but potential wrong-doing may be difficult to identify and interpret. The reader is then provided with discussion as to the known and possible nature of organized crime involvement in capital-market offences. This may include the laundering of externally-generated proceeds of crime, or various fraudulent and related laundering of the proceeds of crime generated from participating alongside or within the securities sector.

It would not be appropriate or sensible for us to identify in this report particular examples as constituting organized crime or meeting the nominal definition. In part, our cautious approach is due to the lack of Canadian court rulings affirming convictions for criminal organization charges in the securities sector. Readers who wish to review particular examples may refer to the lists of disciplined persons and tribunal or court decisions provided on the respective websites of: the Canadian Securities Administrators, Ontario Securities Commission, Autorité des Marchés Financiers, and the U.S. Securities and Exchange Commission.

5.1 The Prevalence of Organized Crime

The prevalence of organized criminal activity, both in general and within specific sectors, is always difficult to assess. The available evidence is not based on systematic, reliable and comparable data within and between sectors of the economy and national jurisdictions. Rather, knowledge is typically derived from incidence data on organized crime cases that come to light as a result of luck, technical and regulatory inquiries and sanctions, civil action by parties to recover damages and losses, and criminal investigations and prosecutions. The data are then used indicatively to suggest how widespread organized crime may be within a particular sector (Fodor 2008). The use of such a variety of sources is broader than many other areas of study where there is reliance on only criminal cases and criminal statistics. The problems of assessing indicative data on prevalence are perhaps more problematic with respect to the securities sector, within which the number of known cases that may involve organized criminal activity (with very modest evidence of Type I and little or no evidence of Type II criminal organizations) is small. The securities market requires a diversity of skill sets, more nuanced understanding of financial enterprise and regulation, and a significant level of cooperation that may not be achievable by the majority of criminal organizations. There is not a large volume of literature on organized criminal involvement in the securities sector. However, we can obtain some insights into the potential prevalence of organized criminal activity in the securities market via the money laundering and fraud literature discussed below.

Reuter and Truman (2004) reviewed 580 money laundering cases provided to the Financial Action Task Force (FATF) and the Egmont Group. These cases were submitted by member states as examples but, unfortunately, are not systematic and randomized samples that would permit authoritative attributions of prevalence. The authors found that fraud accounted for 22 per cent of cases, the second largest category behind drug trafficking at 32 per cent. Wire transfers and the use of a front company or organization, were the largest categories of laundering techniques for both drug and fraud cases. Nevertheless, fraud-related examples illustrated greater emphasis upon more subtle dispositions such as the use of shell corporations, lawyers and accountants and securities. By contrast, drug cases tended to emphasize the

purchase of high- value goods, real estate, and the use of financial instruments, lawyers and accountants.

Stamp and Walker (2007) conducted a survey of 21 overseas financial intelligence units (FIUs), 14 Australian law enforcement agencies, and four researchers and criminologists. They found that the largest predicate offence categories were fraud at 82 per cent and illicit drugs at 11 per cent for proceeds generated within Australia and laundered within or outside of their jurisdiction. In contrast to the historical law-enforcement focus on illicit drugs, it is interesting that the survey found that FIUs reported that fraud and tax/customs evasion offences were far more prevalent than drug trafficking, with respect to frequencies in suspicious transaction or activity reports. These findings indicate a growing emphasis on fraud-related (including securities-related) financial crime reported by FIUs. Criminal organizations and other groups may be capitalizing on a broader range of domestic and international opportunities to generate and dispose of the proceeds of crime and complicate efforts at detection, investigation and prosecution.

In an examination of 149 RCMP money laundering cases for the period 1993-1998, Schneider (2004) found that theft/fraud accounted for 7.4 per cent of the offences that generated the proceeds of crime and 7.4 per cent of laundering cases were conducted via the securities sector. While the study should be viewed cautiously in terms of methodology and analysis, given problems with overlap of offence categories, it clearly illustrates the historical emphasis of law enforcement on illicit drugs into the 1990s, and points to the substantial diffusion of investigative training and expertise to counter such crimes.

Indeed, drug offences accounted for 74.5 per cent of the cases noted in the study of RCMP cases. We should expect greater emphasis on fraud and securities with, for instance, the formation of the Integrated Market Enforcement Team (IMET) program by the Government of Canada in 2003. The IMET and related efforts in major centres across Canada should enhance training, detection and investigation via integration of federal efforts and improved liaison work with regulatory, investigative and prosecution bodies at the provincial (and municipal) level. Greater activism in this area is important, but impact will depend on reciprocal communication between regulators, industry and law enforcement to provide an empirical basis for profiling suspicious activity.

What is clear is that the prevalence of organized criminality is unlikely to be evenly distributed. We would anticipate that the major brokerage houses have the skills and financial and other resources to resist the infiltration of criminal organizations. This does not discount that such firms may be vulnerable to, rather than mafia-type infiltration, the collusion of market insiders and outsiders who effectively form and participate in criminal organizations to defraud investors (Black 2005, Levi 2008). Smaller brokerage houses with limited skills and financial and other resources, including small capitalization, may be more vulnerable. Police data from New York reveals that in 2004 about 8 per cent of small capitalization traded stock firms on the NASDAQ were controlled by traditional Italian-American organized crime families, and since 1989, 82 per cent of arrests for boiler-room scams (see section 4.3 below, pump and dump) involved members of Italian-American criminal organizations (Diih 2005:146, 236).

Levi et al. (2007) estimated the costs of fraud and its impact in the United Kingdom. This study did not emphasize securities-related fraud *per se*, but its findings underscore the potential scope of fraud and the difficulties of measuring its impact. The total conservative estimate of the cost of fraud was placed at £13.9 billion, of which £12.98 billion was from direct losses and £0.937 billion in identified private and public anti-fraud costs. Of the total direct losses from frauds, the rounded averages of the distributions were as follows for each sector or group: public sector excluding income tax/EU fraud/international body fraud (50 per cent), private individuals (21 per cent), business sector supplementary (14 per cent), financial service sector (8 per cent), and non-financial service sector (7 per cent). The total direct estimated losses from fraud represent just over 1 per cent of British annual gross domestic product. However, these are conservative estimates based on an uneven terrain of data collection across the different sectors and groups. This figure has risen to £38 billion according to the National Fraud Authority (2011), though the proportion of this that relates to organized fraud in the securities market remains obscure.

Some have argued that efforts to measure the scale and extent of financial crimes are riddled with serious difficulties that may not be resolved over the medium term, and that the interests of regulators and market participants would be better served by re-focusing efforts. Drawing upon the best available evidence, Dorn et al. (2009) argue the need for a shift towards estimating the impacts of financial and other criminality upon regulated markets, entities and consumers, and to estimate the amenability of different regulatory and other controls in terms of the influence they may have on reducing such impacts. The core aim of this proposal is to develop and implement a framework to generate data in a comparative manner. This would go some way towards establishing baseline data that may be measured over time and used to assess the influence of different regulatory and other controls on the negative impacts of financial crime.

Such a shift would seem appropriate and timely given the limitations of existing data and the unknown dark figure of capital market offences and serious and repeat offending. This is emphasized by an online study of 5,868 individuals across Canada that found that 5 per cent had been victims of investment fraud, 40 per cent had been approached with an investment fraud, and 91 per cent agreed that "the impact of investment fraud can be just as serious as the impact of crimes like robbery and assault" (Canadian Securities Administrators 2007).

The similarities and differences in the domestic and international data presented above makes clear the need for further empirical investigation of the vulnerability of the Canadian securities industry to organized crime and money laundering.

5.2 Why the Securities Sector May Be Vulnerable to Organized Crime Infiltration

Nelken (2007) highlights several key issues that explain why white-collar crime settings, such as the securities sector, are vulnerable to criminality (organized or otherwise). First is the question of whether inappropriate and offending behaviour in the securities market is really crime? Although criminal provisions and sanctions can be used against unlawful activities, the securities sector is a hybrid zone wherein the use of criminal procedure and sanctions tends to be rare, representing as few as 10 to 20 per cent of such cases even in the more aggressive jurisdictions. The primary focus of controls tends to revolve around civil-law measures where stakeholders file

actions, there is regulatory supervision by the authorized market regulators or securities commissions, and technical compliance with industry standards. This has clear implications with respect to limiting the stigmatization and the severity of penalties that may be imposed for violations. Although securities offences may invoke serious harm for individuals, companies and society, the penalties will often be limited to administrative and regulatory sanctions such as fines. Any field with lesser punishment and equal or greater profitability is likely to act as a pull factor to criminal organizations whose members generally face greater law enforcement, potential sanctions, and limited profitability, in standard criminal enterprise such as illicit drugs and other areas. There will also be push and pull factors within and between different regulators and regulatory regimes.

Second, the causes of white-collar crime are not so readily reducible to individual motivation and behaviour as in other areas, such as interpersonal crimes. While some offenders may pre-plan and intend their behaviour from the start, it is quite common to see slippery-slope behaviour. This may occur where individuals are trying to protect their career or organization and keep up with the competitive pace set by others, and especially to maintain the pace set by their organization in a competitive marketplace. Indeed, in the competitive environment of securities brokerages, there may often be little choice but to emphasize performance at the expense of values and ethics (Black 2005). Criminal solutions may emerge as coercive and/or as facilitating, for instance, where criminal organizations or other criminals obtain cooperation from securities industry personnel through threats or intimidation, or in providing a "solution" during periods of business slow-down or personal gambling debts. Individual and organizational social controls may also be reduced in a given securities-related context through rationalization and the de-labelling effects that may be provided by professional service providers such as lawyers and accountants.

Third, the everyday settings in which securities crime may occur tend to obscure potential wrong-doing. Victims may not complain, or may not complain in a timely fashion; typically, because they may not have the knowledge and skills to appreciate that they have been victimized or are too embarrassed to report their victimization. The line between ordinary business practice and crime can be thin, and the specialization of skills and functions may permit the diffusion of clear identification of intent and goals with respect to particular individuals. The private setting and culture of securities brokerages, combined with the substantial volume of ongoing trading activity, makes it less susceptible to supervision and oversight by regulators, investors and the public. There can be a number of scenarios where criminal organizations call on business and vice versa to meet their respective goals or deal with problems that may arise. On the one hand, criminal organizations often have excess cash from the drug trade, prostitution and other illegal activities, and there will be a constant search for ways and means to dispose of crime monies. On the other hand, businesses may encounter problems with competitors that require novel solutions or require access to insiders in other jurisdictions in order to diversify their business interests. It is not always the case that problems and criminal solutions will arise from malevolence among otherwise legitimate broker-dealers. Such problems and criminal solutions may emerge as a product of incompetence that threatens the competitive position of the individual and perhaps the firm in which they work (see slippery-slope discussion above).

Fourth, securities offences may often be doubly victimless where individuals fail to complain due to embarrassment or lack of knowledge, and companies fail to report the violations of rules so as not to undermine confidence in their business. Such areas of low visibility typically require prevention and proactive enforcement. Regulators of securities and other markets are often placed in a dual role where they provide oversight and sanctioning of the broker-dealers and other participants but the regulators are simultaneously responsible for maintaining trust and confidence in the market. This creates incentives towards the use of technical and regulatory solutions using strict liability offences (evidence of the commission of the offence is the standard of proof) as opposed to the stigmatizing effects of criminal proceedings using general liability offences (evidence of mental intent combined with evidence of commission of the offence is the standard of proof). It also creates incentives to rely on the data and risk-management frameworks generated by financial-market insiders, and for regulators to adopt and implement these frameworks rather than developing and implementing them independently to test the market data (Dorn 2010). Further, in many Western countries, sentencing for securities offences has tended to be lax, at least until the 1990s, with a series of scandals in many jurisdictions and with the growth in individual and public investing in the markets.

5.3 The Nature of Organized Criminal Activities in the Securities Sector

There are many ways in which criminal organizations have exploited the securities sector, and many other possible methods by which it might be exploited. Unless otherwise indicated, this section draws upon a study of organized crime infiltration of the financial (securities) market in New York (Diih 2005), which offers detailed insights into methods associated with documented and potential schemes. This sub-section of the paper introduces a number of illegal schemes used in the securities sector. The reader may refer to the previous section for an overview of the structure and function of the securities market in Canada. The reader may also refer to the relevant section below for a discussion of the vulnerability of the Canadian securities market to organized criminal activity, including the known or potential use of the schemes discussed in this sub-section of the paper. We encourage readers to consider this discussion, not only in terms of the stereotypical Type I view of organized crime, but also in terms of the expansive Type II definition that could include a wide range of actors involved in crime and conspiracies in the securities sector.

The securities market may offer a helpful vehicle for criminal organizations to launder the proceeds of externally generated proceeds of crime, for instance, through trafficking in drugs, firearms, human beings, and other illegal goods and services. It is also important to bear in mind that the proceeds of crime may have been produced recently or in the past, and this raises the possibility of otherwise legal companies being a product of, and potentially of current service to, criminal organizations. The proceeds of crime may be parked in securities simply to give the appearance of legitimacy, or such deposits may be for market growth purposes or in an effort to influence particular stocks or companies. Though there will be client identification and other requirements for deposits, the proceeds of externally generated crimes may be placed into the securities market through structured deposits and/or with the assistance of nominee account holders so as to hide the beneficial owner. Once such proceeds are entered into the securities market, the beneficial owner(s) are likely to enjoy further possibilities to move their money around within the market so as to obscure its criminal origins. Nevertheless, this option is likely

to offer little leverage and reduced options as compared with schemes undertaken (apparently or in truth) within the securities market. The leverage and options are reduced because criminal organizations are operating outside of brokerage firms in this context, and are therefore dependent on the knowledge and skills of broker-dealers over whom they may have little or no leverage. Once control is acquired over broker-dealers, or a criminal organization inserts its members into and begins to control brokerage firms, there are expanded possibilities to falsify records and more systematically de-fraud individual investors and other companies (see discussion below).

The fictitious involvement of criminal organizations in the securities sector may be achieved quite simply by setting up real or strictly paper-based companies controlled and or run by members who sell fictitious stocks. That is, to operate outside the regulated market in having unauthorized-securities brokerage houses selling unauthorized stocks. This avoids the necessity of having to obtain the relevant qualifications and be subject to market regulators. In some jurisdictions, the market regulator may pursue brokers working outside of the authorized system, whereas in other jurisdictions this will be left to law enforcement. In either case, unauthorized brokers will have some time to make money by selling fictitious stocks to unsophisticated consumers who may not complain until it is too late or, with some coerced or cooperative assistance from authorized broker-dealers, unauthorized brokers may engage in pump and dump schemes (see below, and Tillman and Indergaard 2008).

The partial involvement of criminal organizations in the securities sector opens up a broader range of opportunities to generate and dispose of the proceeds of crime. Gaining entry and exerting some level of control within this market can be achieved indirectly by securing the cooperation of broker-dealers, compliance officials, managers, owners and others. This may be acquired through the collusion of market insiders, which may be secured overtly via threats or the use of violence or via the involvement of market insiders in illicit drugs activity, prostitution, and debts incurred through illegal gambling and associated or separate loan sharking activities. The co-operation of market insiders can then be used to obtain access to sensitive and confidential organizational and personal information for members of criminal organizations to exploit in their market activities, as well as to engage in a range of false or fraudulent schemes.

Deeper involvement of criminal organizations in the securities sector provides considerable expansion in the opportunities to generate and dispose of the proceeds of crime. This may involve members of a criminal organization establishing partial or direct beneficial ownership of brokerage houses and underwriting firms. Key positions in the firm may often be held by criminal organization members or affiliated individuals, and the firm is then used as a front company to bilk investors who are unwittingly investing in non-existent securities or being subjected to a series of fraudulent practices. The scope of the potential fraudulent practices may be observed with the partial involvement of criminal organizations in the securities sector, however, the range and leveraging of options is much increased with deeper involvement. Below the reader will find an overview of a number of the methods that organized criminals may employ to exploit the securities market.

Complex securities frauds requiring significant amounts of capital are generally restricted to the more sophisticated and adept criminal groups. Common schemes of varying complexity that

have been revealed through police criminal intelligence and research (Criminal Intelligence Service Canada 2010; Diih 2005) include:

- Payment or tribute demands: A criminal organization may issue veiled and explicit threats (e.g., unload its stock holdings) to damage companies unless pay-offs, jobs, contracts or other tributes are granted to the representatives of the criminal organization (Kaplan and Dubro, 2003).

- Insider trading: Obtaining access to confidential information and/or falsifying information to artificially influence the value of a given stock and, with the coercion or cooperation of broker-dealers, buy and sell stocks at the expense of investors who do not have access to insider or confidential information (Szockyj and Geis 2002).

- Illegal Market Manipulation or Pump and Dump: Supposedly low-risk and high-yield investments such as penny stocks ($1 value or less) are aggressively promoted via boiler room (telemarketing) or online promotions to sell individuals (often the elderly) securities that do not exist, or are dumped at an elevated price fixed by the organizers of the scheme.

- Illicit tax-free investments: These can include high-return and "tax-free" investments in domestic or offshore markets, falsified statements for broker/brokerage and client tax purposes, donations of false or artificially valued stock to non-profit or charity organizations, all of which may cause the investor to lose her money and incur potential liabilities for taxes and penalties.

- Fraudulent High-Yield, Pyramid or Ponzi investments: Through chain letters and fraudulent issues for non-existent or over-valued shares, the underlying basis of high-yield "profits" is the money of new investors, and the scheme collapses when there are too few new recruits or too many withdrawals.

- Professional Service Providers: Lawyers and accountants can (whether implicitly or as corrupted parties) instruct and advise securities brokerages on how to structure their accounts and transactions to avoid market regulators and law enforcement, to help clients de-label and reduce the stigma of inappropriate conduct, and to thwart regulation and enforcement via delaying tactics and the use of offshore banks (Block and Griffin 2002; Tillman 2009)

Whereas there may be occasional examples of traditional (e.g., mafia-type) organized crime groups and their involvement in the sector, successful functioning in the securities market often requires a complex set of skills. Thus, criminal infiltration of the securities market will tend to involve fluid networks of traditional criminal organizations and criminal entrepreneurs, and the intentional or coerced involvement of business people, financial services personnel, professional service providers (lawyers, accountants), and bureaucrats in compliance and other gate-keeping roles (CISC 2010; Diih 2005; Levi 2008; Sliter 2006, 2007).

6. Securities Sector Vulnerability Analysis

This section of the report provides a micro-level analysis and depth scan of crime (organized crime) vulnerabilities in the Canadian securities sector. This analysis will draw upon the research and interview (N=20) data (See Appendix A: Methodology) collected for this report and an overview of criminal intelligence data.

6.1 Interview and Research Data

There was a general consensus among interviewees that opportunities to commit fraud were directly connected to observable vulnerabilities within the securities sector. The asymmetry between investors and (potentially fraudulent) market actors within or outside of the securities sector is fundamental to the scope of vulnerabilities. This is represented by the variable timeliness and transparency of financial and other information disclosures by market actors and investor access to relevant information. The timeliness and transparency of information is a direct product of regulatory oversight, both in terms of static rules on listing and reporting requirements and dynamic regulatory influences such as market surveillance, audit, investigation and sanctions.

For instance, the regulations and controls utilized by the IIROC (2010 a,b,c) offer perhaps the benchmark standards for the securities sector in Canada. This includes registration and qualification requirements for dealer-brokers and brokerage firms, and an extensive variety of compliance requirements for trading activities including anti-money laundering efforts. While members are required to follow rules, the IIROC also employs various compliance and investigation oversight activities, including the Universal Market Integrity Rules (UMIR). The UMIR program provides not only a common set of rules for trading on Canadian markets; it also has the power to quickly reverse inappropriate trades and enforce cease-trade orders.

This should not be taken to imply that criminal activities do not take place within the regulated securities market in Canada, and such incidents do occur. The point is that vulnerabilities in the regulated securities market are substantially moderated, and that incidents are most likely to occur where there is a breakdown in gatekeeper functions. That is, in cases where investors, brokers or brokerages fail to execute standards of due diligence. For instance, where criminal groups obtain control over investor accounts or are able to direct the structure and functioning of companies with trading shares (La Presse 2011). Other examples may occur where there are inadequate checks for money laundering such as deposits using nominee individuals and accounts to obscure the beneficial owner, and movements of large volumes of money into or within securities without an appropriate or underlying economic basis.

The greater vulnerability in the less- or un-regulated securities markets is exposed by the information and disclosure asymmetry between investors and market actors as well as the reduced oversight of regulators. Interviewees expressed particular concerns about international markets such as pink sheets and the Over-the-Counter Bulletin Board (OTCBB) in the United States, the Frankfurt Stock Exchange (FSE) in Germany, and domestic markets such as exempt securities.

The pink sheets are a part of the OTC Markets Group Inc. It is a market run by (qualified) independent brokers that offers over-the-counter trading in company securities. These typically do not meet minimum requirements for listing on a U.S. stock exchange. They may be traded with no disclosure of company information (unwilling or unable to disclose to public markets), limited information (unwilling or unable to meet disclosure guidelines), and current information (some public disclosure of information in the last six months). The first category is clearly the most vulnerable to suspicious activity, but the pink sheets in general are deemed highly speculative and high risk for investors. The underlying companies may be subject to regulation, but their securities-trading activities on the pink sheets are variably regulated. Investors can only purchase at the bid price if a broker, in this marketplace run by brokers, is willing to sell to the investor. With lax regulation for becoming a listed company, loose reporting requirements and lack of monitoring, investors in the pink sheets are at risk of various forms of manipulation.

The reader should be aware that OTC Pink is the third distinct category with the least company disclosure on the OTC Markets system for broker-dealer trading in unlisted securities. The first category is OTCQX that contains U.S. companies registered and reporting to the U.S. Securities and Exchange Commission (SEC), or a regulator in the relevant sector, and must meet financial standards and review or audit requirements. The second category is OTCQB that are not registered with the SEC, but are providing substantial disclosure to the SEC or a U.S. regulator in the banking sector including audited financials and disclosures so that investors may confirm information.

The Over-the-Counter Bulletin Board (OTCBB) is an inter-dealer quotation service for trading in equity securities that are not listed on U.S. national securities exchanges such as the NASDAQ. The OTC Pink Sheets has emerged as a significant competitor in this market. Companies on the OTCBB must comply with SEC filing requirements but they are below (or have fallen below and been de-listed) the minimum requirements for listing on the established exchanges such as the AMEX, NASDAQ and NYSE. These include having little or no market capitalization, a lack of corporate governance, and share prices that fall below a minimum threshold. These are generally referred to as penny stocks, and with share prices below one dollar and low market capitalization, which are subject to greater potential for fraud.

The Frankfurt Stock Exchange (FSE) is divided into four (tiers) segments that include the “first quotation board” and “entry standard” that are unofficial markets subject to self-regulation by the FSE alone, and the “general standard” and “prime standard” that are regulated markets subject to European Union standards for transparency. The first quotation board is subject to little restriction or transparency and disclosure requirements. Indeed, all shares are considered “free trading” without restrictions for company officers and insiders, and there are no requirements for a prospectus or audit of company records for companies listing on this FSE segment. The FSE boasts of “massive exposure” to investor capital and greater liquidity than all exchanges in the world save the NYSE and NASDAQ.

The three examples above (pink sheets, OTCBB, and FSE) are international markets, but interviewees also identified concerns with less regulated domestic markets. For instance, the exempt securities market is a Canadian segment of the industry subject to many of the standard

requirements but enjoying particular exemptions. Dealers are required to register and are subject to the regulations of the relevant provincial securities commission, including qualification of dealers, audited financial statements, record keeping and disclosure of conflicts of interest. Exempt market dealers (EMDs) are not subject to full prospectus disclosure and have greater flexibility to engage institutional and accredited (sophisticated and/or high net worth) investors or eligible investors who qualify for the purchase of exempt securities under an offering memorandum. This raises obvious concerns about the potential asymmetries between investors and broker-dealers, but also that the exempt market may be used as a back door to engage in brokerage activities that would ordinarily be subject to more intensive regulation by IIROC, MFDA and others. Readers may refer to the Exempt Market Dealers Association of Canada (EMDA) for additional information.

6.2 Criminal Intelligence

The first strategic intelligence assessment on capital-market fraud in Canada since the creation of the IMET program has been conducted by the RCMP Criminal Intelligence and Integrated Market Enforcement Branch (RCMP 2011). The assessment involved a review of investigative, intelligence, information and assistance files reported over an 18-month period. This involved reports received from 26 municipal and provincial law enforcement agencies responsible for the largest population densities in Canada, but excluded a further two enforcement agencies unable to respond to the request for information. The assessment confirms the importance of structural vulnerabilities of greater or lesser regulation (see above) in understanding the known activities and abilities to commit capital-market fraud. The distribution of known or suspected offences and violations in the Canadian securities market was as follows:

Table 6.2.1: Distribution of Known/Suspected Offences in Canadian Securities Market

• 19% Market Manipulation • 19% Investment Misrepresentation • 16% Illegal Distribution • 11% Boiler Rooms • 10% Ponzi Schemes • 6% Fraud	• 6% Other • 5% Insider Trading • 3% False Prospectus • 3% Embezzlement • 1% Broker Misconduct • 1% Forgery

Source: (RCMP, 2011)

Analysis of reported enforcement occurrences in Canada indicates the marketplaces most often exploited in fraudulent market activity were:

- 63 per cent International markets (pink sheets 37 per cent, OTCBB 25 per cent, Frankfurt Exchange 15 per cent) [sum exceeds the aggregate due to multiple exchange listings]
- 33 per cent Domestic markets (TSX 14 per cent)

The most common products are equities, mutual funds and promissory notes, which ties into the nature of the common schemes that offer returns based on an underlying asset that may or may not exist or exist as advertised. This also ties into the more vulnerable sectors such as mining

and energy where investor oversight or understanding of valuation may be more difficult. One-half of occurrences related to the financial-services sector.

There appear to be differences in the schemes prevalent within the provinces. For instance, in Ontario it is more common to see boiler-room operations involving shell corporations or reverse takeovers and corporate identity hijacking, and Ponzi schemes including the use of foreign-exchange trading systems. In Québec, there appears to be greater emphasis on market manipulation that relates to acquiring access to registered investment funds, funds transfers and the artificial inflation of accounts and relevant investments. The most commonly reported groups were Outlaw Motorcycle Gangs (OMGs) and Traditional Organized Crime (Italian), with the latter involved in much of the activity in Québec.

Nine out of 10 victims were Canadian residents and, due to the overlap of some schemes, nearly one-quarter of victims were U.S. residents. The victims ranged from a small number of individual investors to as many as 3,000 individuals and entire corporations. Nearly one-half of occurrences involved repeat offenders known to law enforcement or regulators, and concerns were raised as to whether the remaining occurrences involved opportunistic or undetected repeat offenders. The category of repeat offending is particularly troubling with respect to criminalized third-party professionals (securities lawyers, investment advisors and accountants) who may often be active as nominees or involved in the conducting of transactions.

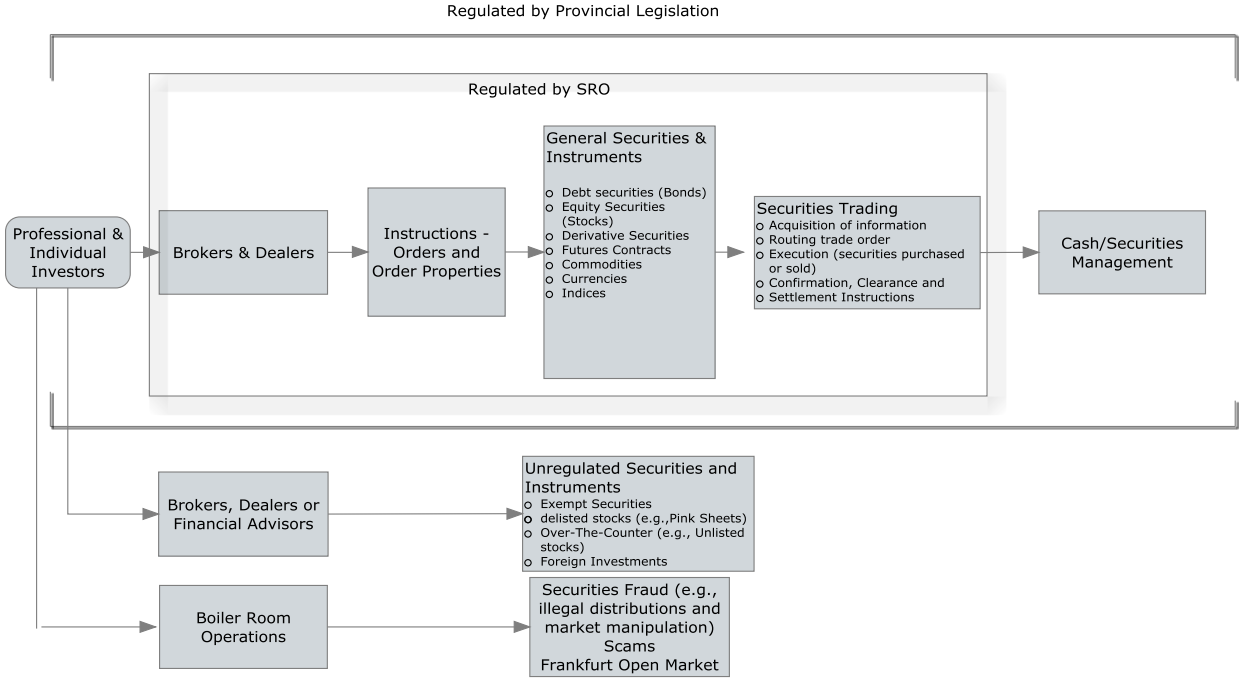
Although it is clear that money laundering is inherent to fraudulent capital-market activity, the focus tends to go towards underlying predicate offences (often fraud) rather than money laundering per se. This is likely a significant lost opportunity to understand the nature and scope of malfeasance in Canada's capital markets. First, the reported occurrences involved estimated investor losses of under $1 million, into the tens of millions, and a minority of occurrences involved losses of over $100 million. Second, the movement of such amounts would involve AML compliance filing of STRs, LCTRs, and EFTs. These reports should be capable of providing useful tactical and strategic intelligence on repeat offending, the possible presence of criminal organizations, and the involvement of third-party professionals. It is not clear that the full range of regulatory, money laundering compliance, and criminal data are being exploited in a comprehensive and comparable way to better understand and target misconduct and serious repeat offending in Canada's capital markets (Cf. Brennan and Vaillancourt 2011; FINTRAC 2011; IIROC 2010c; RCMP 2011).

7. Findings – Vulnerability Profile

This section offers a vulnerability profile, which integrates the macro-level environmental scan of the literature, the meso-level securities-sector overview, and the micro-level vulnerability analysis of the securities sector. It begins with a summative overview of the potential vulnerability to organized crime in the securities sector. This is based on the data available for this study and the limitations given the lack of specific organized crime prosecutions and convictions within the sector in Canada. In the discussion that follows, a key aim is to identify the extent to which this study contributes toward the research literature on violations and offending in the capital markets.

Figure 7.1 provides a generic overview of the securities-trading process in Canada with a dichotomous division between: (1) markets and activities subject to provincial securities legislation and (2) less regulated or un-regulated sectors within Canada or foreign markets accessible to Canadian residents. Market integrity is promoted within the jurisdiction of Canada via provincial and territorial securities statutes wherein SROs are delegated with many of the regulatory functions and sanctions, provincial or territorial securities commissions address more serious (criminal) violations, and the most serious cases are addressed by IMETs or other law enforcement agencies.

Figure 7.1: The Securities Trading Process in Canada



The vulnerability of the securities sectors to organized crime can be determined by using qualitative and quantitative approaches. For the purposes of this project, vulnerability is classified in three categories:

- Low vulnerability: Indicates that the criminal exploitation of a component of the securities sector is unlikely.
- Medium vulnerability: Indicates that the criminal exploitation of a component of the securities sector is moderately likely.
- High vulnerability: Indicates that the criminal exploitation of a component of the securities sector is very likely.

In terms of the vulnerability assessment, the information from the figure above has been inputted into the table below. The indicators illustrate varying vulnerability scores in the securities industry. However, the overall score for the sector and many of the activities and actors, based on current data, is "low vulnerability," given that the bulk of transactions are conducted through the regulated parts of the sector. Despite the potential size and scope of the dark figure of capital- market offences, the demonstrable scope of securities offending is low in the areas subject to provincial and territorial legislation, securities commissions, and the relevant SRO.

Regarding the vulnerability of the investors, professional investors have a much higher professional expertise and experience in the securities industry. Although they may take greater investment risks, this is counter-balanced by their enhanced capacity to collect information and analyze relevant data. By contrast, many individual investors may not have the knowledge, expertise, or access to the trading platforms to make decisions that are as informed as their experienced counterparts. Individual investors are generally not subject to compliance frameworks for securities trading and, consequently, such investors have a high vulnerability rating.

Table 7.1: Overview of Securities Sector Vulnerabilities

Securities Trading Processes	Vulnerability Score
Investors – Professional	LV
Investors - Individual	HV
Brokers and Dealers that are Regulated by SRO	LV
Brokers and Dealers not regulated	HV
Boiler Room Operations	HV
Instructions – orders and Order Properties	LV
General Securities and Instruments	LV
Securities Trading	LV
Cash/securities Management	LV
Unregulated Securities and Instruments	HV

Several activities and markets receive a high vulnerability rating, and these typically fall outside the framework of regulated securities trading in Canada. This includes the domestic exempt-securities market, wherein no prospectus is required and other standard disclosure requirements are reduced. This reduced state of regulation or lack of regulation is also found in foreign markets such as the pink sheets, OTCBB, and the Frankfurt Exchange. Such investment markets and related products have a high vulnerability rating, as many of these companies may not meet (or may have dropped below) the minimum listing requirements on a standard stock exchange.

The assessment of vulnerabilities to crime and organized crime in the Canadian securities sector remains at a generic level due to the modest volume of criminal convictions and the current

absence of organized crime convictions in Canada. The discussion below highlights how this study may have contributed to the literature and the challenges of developing more detailed insights into vulnerabilities to crime and organized crime in the securities sector.

The prevalence of organized crime within specific sectors remains difficult to assess due to the reliance on indicative estimates based on case examples that come to attention through regulation, civil action and criminal investigation and prosecution. Studies using such data have suggested that fraud (not limited to securities) may account for 22 per cent of international money laundering (Reuter and Truman 2004), whereas others have found that this category may account for 82 per cent of money laundering for proceeds of crime generated in Australia (Stamp and Walker 2007). Research in the United States found that traditional organized crime families tend to concentrate on boiler-room securities scams and small capitalization firms and brokerages rather than the major brokerage houses (Diih 2005). A study in the United Kingdom conservatively estimated £13.9 billion in annual losses from public and private fraud (not limited to securities), representing just over one per cent of British annual gross domestic product and impacting the public, private, financial services and other sectors (Levi et al. 2007). This figure has risen to £38 billion according to the National Fraud Authority (2011), though the proportion of this that relates to organized fraud in the securities market remains obscure. A Canadian study revealed that 7.4 per cent of RCMP cases in the 1990s involved money laundering (mostly drug-related) via the securities sector (Schneider 2004).

Various searches and interviews with stakeholders conducted for this study reveal that there are currently no known cases of securities violations where a Canadian court has published a criminal organization conviction under s. 467.1 of the *Criminal Code* as amended in 2002. There appears to be one criminal organization and securities case in Canada for which charges were laid in 2011 and the court case is pending (*La Presse* 2011). With carriage of the bulk of criminal capital-market offences, the RCMP IMET program has charged 30 individuals in 13 cases involving approximately $627.4 million in estimated losses to investors from 2003-04 to May 2010 (Public Safety Canada 2010). Most of the charges are laid under the fraud provisions of the *Criminal Code*.

The volume of regulatory and criminal violations associated with cases concluded by securities regulators and SROs in Canada is also modest. There were 178 proceedings across Canada in 2010 that resulted in 174 concluded cases, involving 301 individuals, 183 companies, and over $122 million in fines and administrative penalties, restitution, compensation and disgorgement applied against the entities and individuals (Canadian Securities Administrators 2010). In an industry of 2,121 firms and 121,841 individuals, a rough calculation shows that 0.0025 or two-and-a-half tenths of one percent of registered individuals (i.e., 301 ÷ 121,841) and 0.086 or 8.6 per cent (i.e., 183 ÷ 2,121) of registered firms were a party to concluded cases in 2010. Given that individuals are subject to the most severe potential penalties such as imprisonment, a minor proportion of the less than three tenths of one per cent of registered individuals associated with concluded cases may connect to the more serious and repeat examples of offending in the securities market.

Given the limitations of efforts to assess prevalence, researchers argue the need for the development and implementation of a framework to generate data in a comparative manner

(Dorn et al. 2009). The goal is to shift our focus from prevalence estimation based on incidence towards understanding impacts on markets and consumers and amenability to regulations and controls. The analytical limitations of the operational-oriented data above highlight the need for such a shift, not least in the troubling potential scope of the dark figure of capital market offences and of serious and repeat offending in particular. Indeed, it was found that 5 per cent of residents across Canada had been victims of investment fraud and 40 per cent had been approached with an investment fraud (Canadian Securities Administrators 2007).

The vulnerability of victims is inherently connected to asymmetries between investors and market actors. There is an inverse relationship between investors' vulnerability and their access to timely and systematic disclosure of securities information. This impairs the ability to assess the risks of particular investments, and to independently assess the value of assets underlying a given security. While it may not be politically correct or appropriate to appear to be blaming the victims, it is also clear that investor failure to exercise gatekeeper and due-diligence functions is a significant contributor to vulnerability. A breakdown in investor gatekeeper functions can produce significant vulnerabilities to exploit any securities market, including regulated Canadian markets that may appear less structurally vulnerable. These gatekeeper functions can include basic research using the internet to locate investor guidance information from Canadian and other reputable regulators. These tools can be used to guide further research, such as investor checks on reputable databases for the registration of securities dealers/brokers and brokerage firms, and the identification of individuals and firms who engage in violations or offending and repeated occurrences in particular. In fairness to existing and potential investor victims, the infrastructure to support investor due diligence may be too complex and inaccessible for many. It does not appear that the technologies that have supported expanding domestic and international market access have been met with parallel expansion of infrastructure to support accessible and integrated approaches for investors to conduct due diligence. The focus of the expansion of technologies relating to market access appears to be its capacity to drive revenue increases. We do not discount the importance of basic investor-education programs, as individuals searching for answers may generally be less vulnerable to common schemes.

The vulnerability generated by potential offenders also tends to follow the expansion of asymmetries between investors and market actors – that is, where potential offenders engage in behaviour that serves to reduce the quality, quantity and timeliness of financial disclosure to investors. One of the warning signs may occur where companies are headquartered in one country, but registered or incorporated in jurisdictions that require little transparency and have few reporting requirements. Such jurisdictions may have little or no requirement for the disclosure of prospectus, director information, and financial statements as well as controls on trading in company shares by directors and others. This can also directly or indirectly contribute to a lack of independent oversight or investor ability to value the asset underlying the value of a given securities product. Further indicators of vulnerability may occur where there is considerable change associated with companies. This may involve the re-animation of dormant companies that have not been involved in securities trading for a period of time, or the use of many shell companies that have little or no other business or securities trading activity relevant to the business in question. It could also include reverse-take-overs (RTOs) related to dormant or shell companies and the creation of multiple listings on securities exchanges despite the lack of related business between parent and subsidiary companies. Vulnerabilities relevant to offenders

will also be a product of the extent to which market actors perform appropriate due diligence and exercise their gatekeeper functions. That is, to know their clients, file AML reports on suspicious and large cash transactions, and ensure they are providing investment advice and guidance appropriate to their client's needs and interests.

The vulnerabilities associated with market regulators and enforcement are central to the asymmetries between investors and market actors. Structurally, there is a wide range of domestic and international securities market opportunities and the scope of regulations vary widely. Such variance can be seen in static regulations such as prospectus, company director and financial statement disclosure differences between senior and junior markets. It is also apparent in the differential availability of dynamic regulation such as review, audit and investigation and especially the intensity and independence of market surveillance. The communication and information-sharing between regulatory agencies and law enforcement appear to be focused on tactical or investigative needs and there is an issue of overlapping mandates that may obscure serious crime activities. That is, law enforcement have responsibilities to deal with crime and organized crime, but securities regulators have responsibilities to target regulatory violations and some criminal market offences along with some having mandates to foster anti-money laundering compliance. It is not clear that the whole is more than the sum of its parts, given the lack of systematic and comparable data collection on capital market violations and crime, particularly those involving repeat offending and victimization and possibly the presence of organized crime.

The dark figure of crime and organized crime in the Canadian securities sector is impossible to assess because there appears to be no systematic and comparable data collection for capital-market offences in the throughput of data collected by regulators and law enforcement. One would assume that the filing of suspicious and large cash transactions in the securities sector would substantially contribute to the detection of repeat offending and victimization. Nevertheless, it is unclear whether money laundering compliance data are being systematically used to better understand the vulnerabilities to crime or organized crime in the Canadian securities sector. The vulnerabilities relevant to market regulators and enforcement relate to the separate and cumulative performance of their gatekeeper functions. The number and extent of variation across jurisdictions, within Canada and beyond, constrains the ability to fully exploit available technologies to assist investors in performing effective due diligence and minimizing opportunities for exploitation in their asymmetrical relationship with market actors.

The four key issues highlighted by Nelken (2007) to explain why white-collar crime settings such as the securities sector are vulnerable to criminality (organized or otherwise) are consistent with the findings of this study. Inappropriate and offending behaviour in the Canadian securities market is often not viewed or treated as crime, and this is connected to the prevailing regulatory view and treatment of misconduct. Individual investors are at a considerable disadvantage to market actors, and the former may often not appreciate that they have been victimized or report their victimization in a timely fashion. The prosecution of criminal securities cases in Canada is very limited and mostly undertaken by IMETs due to the specialized and costly nature of investigating and securing convictions for such offences. Given the complexity of securities cases, prosecutors often prefer to reduce the scope of charges to the categories most likely to secure a conviction such as drugs or fraud. There are few incentives to add criminal organization

charges to a prosecution as this complicates proving a case, particularly where the defendant elects for a trial by jury, and this adds to the cost of otherwise costly prosecutions against securities-related offenders.

The indicative vulnerabilities and efforts to counter these become more troubling when one considers the nature and pace of change in the securities market, including proposed consolidations of exchanges and concentration of exchange ownership, and the creation of new securities markets. For instance, there have been proposed mergers of exchanges in North America with their counterparts in Europe to create extensive and integrated capital markets spanning various securities products and territories. This raises obvious concerns about variable regulation and standards across regulatory regimes within and between jurisdictions, and information sharing between regulators and law enforcement. The securities market is also marked by innovation and new developments such as the rise of alternative trading systems (ATSs) that compete with established exchanges through enhanced use of technology to increase efficiency and reduce transaction costs for investors. The Kyoto Protocol in 1997 and parallel efforts have created a market for the trading of carbon allowances and offsets. The introduction of ATSs, carbon markets, and other new exchange and securities products may create a context in which investors will not have the information and knowledge to effectively reduce their vulnerability to manipulation and fraud.

8. Conclusions

There are many approaches to reducing and preventing crime, and many existing and prospective measures may be used to reduce and prevent organized crime in priority areas such as the securities sector. In their review of a variety of projects and efforts to tackle organized crime, Levi and Maguire (2004) note the continuing emphasis on traditional law-enforcement strategies and the generalized lack of impact evaluations other than limited designs. These designs typically involve the use of crime rates following the introduction of a given program to identify its potential impact, or a comparison of crime rates before and after the introduction of a given program to assess the potential impact.

It is clear that the complexity of the Canadian securities market presents certain challenges in terms of the design of effective countermeasures. Ultimately, the securities sector represents a difficult focal point in the alignment of public, state, and corporate interests (Nelken 2007). Everyone has a vested interest in economic growth and prosperity, and we all have interests in protecting ourselves from financial and other risks, including the risks posed by organized crime. This places government at the centre of a difficult balancing act between promoting internal and foreign direct investment, and providing a structure of regulatory and other controls that does not push investors to less restrictive jurisdictions while simultaneously protecting consumers from fraud committed by organized crime and other actors in the securities sector. The global financial crises of 2008 and their aftermath provide an opportunity to re-consider the democratic accountability of financial markets and to open up discussion of risk management models (Dorn 2010). It is odd that new information and communication technologies (ICTs) so vital to

financial markets and fraudsters are comparatively under-utilized to promote transparency and accountability to investors and the public (Almiron 2007).

A detailed examination of the risks of infiltration can, therefore, provide a helpful vehicle to reduce and prevent the presence of organized crime, and potentially foster a culture within financial markets less conducive to abuse. A study of organized crime infiltration of the financial market in New York offers a helpful and practical set of considerations (Diih 2005) that aim to take the profit out of securities-related crimes and violations through attention to: (1) market forces and (2) control systems.

First, we need a clear understanding of market forces, such as the growth in securities by volume, and as an increasingly important vehicle to support private and public goods in terms of capital formation and pensions as well as other investments. It is important to situate crime seriousness and criminal opportunities within the larger volume of lawful activity, as this will assist efforts to understand the potential harm, prevalence, and opportunities for situational and structural prevention. The profile of white-collar crimes needs to be elevated, and regulators, criminal-justice officials and the media could do this by placing greater emphasis on public shaming and stigmatizing. Although the specific deterrent effect on organized crime and other committed offenders may be limited, the reputational damage and economic implications may deter poor practices on the part of established individuals and firms as well as any direct or indirect material support they may provide to individuals or groups linked to organized crime. We might consider a range of surveillance and more effective controls on brokerage houses such as effective background checks on employees and placement agencies providing temporary, seasonal and permanent employees to brokerage firms. Financially-troubled brokerage firms and their directors (or their nominees) could be prohibited from re-branding their companies and re-issuing stock options, and could be de-listed or required to undergo enhanced surveillance.

A culture of lawful and ethical behaviour can also be promoted through government efforts to better educate the public and investors about market processes. This could be particularly helpful with respect to how to identify indicators of risk and fraud, and the range of options to undertake timely preventive and remedial action (Evola and O'Grady 2009). This can be cost-effectively supported via Internet education with the links provided in pamphlet form to new and existing investors. The quality of such educational materials can be enhanced through periodic domestic and international conferences of law enforcement, regulators and government, academia, and industry. These conferences could aim to facilitate the exchange of practitioner ideas and control approaches to identify and reduce loopholes, and include an ongoing effort to provide evidence-based messaging to the public on indicators of risk and options to reduce and prevent such risks. Such exchanges could further include an emphasis on improved compliance through incentives and disincentives that appreciate the differential susceptibility of brokers, managers and corporations to involvement in market abuse and the reporting of indicators of such abuse. A core support to education in this area would be greater funding for empirical research on priority topics of corporate governance, ethics, fraud networks and organized crime, and assessments of harm impact, and evaluations of counter-measures (Kalbers 2009).

Such a culture against market abuse must include the central principle of proportionality between the harm inflicted upon individuals and companies and the sanctions imposed upon offenders.

Financial penalties of up to 20 per cent of a determined fraud level in a given case are inadequate to act as a specific deterrent to those involved in a particular scheme and create little in the way of general deterrence within the market.

Second, we therefore need a clear understanding of the limitations and possibilities of control systems that can be used to take the profit out of securities crime and violations. There may be valid cultural and legal reasons for separate regulatory and enforcement agencies and corresponding mandates. Nevertheless, control agencies need to function as interdependent (rather than strictly independent) agents within a clear set of defined goals and a coordinated strategy to detect and deter violations and to reduce impact and harm by issuing proportionate sanctions. Stakeholders could consider research and policy development into the design and implementation of a national data collection and securities intelligence model. This could help to improve the separate and cumulative detection and deterrence of serious repeat offending in Canadian capital markets, and its potential utility as a vehicle for criminals and organized crime and build upon existing reporting standards and models (Ogrodnik 2002; Canadian Centre for Justice Statistics 2008). This could provide invaluable tools for strategic assessments of vulnerabilities across the sector, and assist regulators, SROs and law enforcement in targeting serious and repeat offenders.

This will require detailed insights into the nature of the market and corresponding problems, and a problem-solving orientation in understanding and applying the full range of industry regulation, public regulation, enforcement and prosecution using criminal and civil law (including civil forfeiture where available), and rules and regulations. For instance, money laundering legislation and rules may provide invaluable insights into suspicious and large cash transactions outside of and within the securities market (Lai 2010). Such legislation and rules were originally created to target drug-related laundering and thus may require some adaptation and fine-tuning to capture the more nuanced laundering associated with securities.

This could also be enhanced by a set of practical steps to enhance control efforts. This would include greater emphasis on the ability to identify indicators of risk and investigate fraud using sound forensic and other systematic techniques on the part of regulators, law enforcement and internal corporate investigations and audits (Coburn 2006; Hillison et al. 1999). The development of an integrated and comprehensive Canadian national data collection and securities intelligence model would go a long way towards understanding the separate and cumulative contributions that could be provided by concerned parties such as regulators, enforcement, industry members, academia, and victims. This could provide a valuable platform from which the government and regulators could issue accurate and timely warnings to the public and reduce or disable criminal opportunities for individuals linked to organized crime as well as independent fraudsters.

Helpful tactical and strategic advantages may be derived from distinguishing the susceptibility of different market players towards promoting a culture of lawfulness in the securities market. This could include targeted incentives for law-abiding firms and individuals, and focused disincentives to the variable networks of individuals and groups involved in organized crime, whether cooperative or coerced, and the broader networks of securities fraudsters. The latter could aim to reduce the network diffusion of skills and knowledge on transferable criminal skills

and opportunities as well as the potential diversification of organized crime. Consideration could also be given to minimizing or eliminating some of the restraints on enforcement and control methodologies that may be used to regulate the securities market. For instance, the Mr. Big Strategy (having criminals confess their sins so as to gain access to the "big leagues of crime") has been effectively applied by the RCMP to target those involved in gangs and other forms of organized crime, and this could be usefully applied to the securities market. The strategy would be enhanced by addressing the tension between evidence and prevention priorities, and the associated allocation of budgetary resources to effectively target and dismantle priority organized crime groups and schemes. Given the perennial challenge of limited public resources, strategic decisions need to be made with respect to the quantity and the quality of market regulation and control (Fodor 2008). The present report attempts to provide readers with a detailed and accessible review of Canada's capital markets, its regulatory and control systems, and the nature of offending and victimization therein. We leave readers with the concluding thoughts that:

> The efforts aimed at controlling white-collar crime must follow non-traditional problem-solving approaches. Control agents must first recognize and fully appreciate the extent and dimensions of securities fraud before attempting to design a determined course of action or response in dealing with the problem. These control measures must be designed not only to target criminal groups and the types of behaviour they engage in but should also focus on major financial houses and ill-informed high-risk investors who are culpable in fuelling the culture of fraud on Wall Street [and other securities markets]. (Diih 2005: 39)

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Appendix A: Methodology

The method for assessing the vulnerability of sectors (MAVUS) offers a systematic approach to analyzing the opportunities that may be exploited by criminal organizations. Developed with funding from the European Commission, it offers pan-European insights with methodological and analytical contributions from the universities of Ghent, Trento, Amsterdam, Frieburg and Cardiff. It has been successfully applied to a variety of economic sectors such as waste management and road freight transport (Daele et al. 2007, Vander Beken 2005, Vander Beken et al. 2005, Lavezzi 2008, Savona 2006a,b). We will not slavishly follow every element of this method, but instead apply it systematically and with respect to the relevant and available data in the Canadian context.

The MAVUS system involves the gathering and analysis of information in five separate but interrelated phases: macro-level environmental scan, meso-level sector overview, micro-level reference model analysis, findings and analysis of indicators, and conclusions and considerations for policy. In the main body of the above paper, readers will note that the sector overview is placed before the environmental scan. This structure was used for clarity of messaging even though the process for producing the material followed the MAVUS sequence below.

First, a macro-level environmental scan of the literature is conducted on the environment external to the sector under study. The aim is to develop a cluster analysis of the relevant trends and broader context surrounding the sector. It may include political, economic, social and technological developments and the associated impact for regulation and interaction with other connected sectors. Special emphasis is placed on the context of criminals and criminal groups that may interact directly or indirectly with the sector. The interest at this level of analysis is how criminal activity may be conducted in the sector and how firms may become victims, facilitators or enablers, or accomplices in criminal activity. The data used in this review included scholarly works, commission reports, grey literature such as industry reports and unpublished academic dissertations and theses, and government and non-governmental research.

Second, a meso-level analysis is conducted on the sector and its relevant features, including market features. This may include attention to factors such as accessibility and entry barriers in the sector, and qualifications and regulation of participants. Relevant data was obtained and analyzed from government sources such as Statistics Canada, Industry Canada, and industry sources operating in the securities sector.

Third, a micro-level analysis is conducted on the task environment and functioning within the sector and the identification of its general and specific vulnerabilities or opportunities for crime. This will include the mechanisms for purchasing and trading in securities and the rules and regulations that are prospectively and retrospectively applied to such activities. Consultations and semi-structured interviews were conducted with a range of stakeholders to obtain relevant macro- and meso-level information, and to obtain specific micro-level information on vulnerabilities. Twenty (N=20) stakeholders participated in interviews that involved the following organizations:

- Autorité des Marchés financiers (AMF)
- Canadian Securities Administrators (CSA)
- Crown Law Office – Criminal (Ontario)
- Financial Transactions and Reports Analysis Centre of Canada (FINTRAC)
- Investment Industry Regulatory Organization of Canada (IIROC)
- Mutual Fund Dealers Association of Canada (MFDA)
- Ontario Securities Commission (OSC)
- Public Prosecution Service of Canada (PPSC)
- Royal Canadian Mounted Police (RCMP), Integrated Market Enforcement Team (IMET)
- Securities Broker (Banking Sector)

The data derived from participants was assessed and combined with additional industry data and available criminal intelligence.

It is important to point out that while the first three stages are similar in purpose, as they are information-gathering activities, they differ in the level at which information is gathered. The first two stages constitute the width scan, which aims to provide a broad overall assessment of vulnerabilities emerging from a cluster analysis of the surrounding context and a sector analysis of the industry and its market features and functioning. The third stage constitutes the depth scan, which aims to identify specific business processes most relevant to assessing opportunities for crime.

The intent of the MAVUS approach is to gather and analyze data at multiple levels and then to integrate the data into further analysis that is more than the sum of its parts. A vulnerability assessment offers a process to identify, qualify or quantify, and prioritize existing and emerging threats to the assets and systems of a given sector. It also offers the opportunity to elaborate on existing and potential policy options to mitigate or respond to concrete threats.

The fourth stage, the findings and analysis, provides for the development and analysis of indicators at multiple levels, to form a vulnerability profile. This includes vulnerabilities identified in the width scan of the environmental context and sector-specific factors, and the depth scan of the task environment and functioning of the sector. The desired outcomes should be supported by the logic model, however, the desired outcome is directed at balancing the contributions of the information gathered at the macro-, meso-, and micro-levels of analysis.

The fifth stage, the conclusions and considerations for policy, uses the vulnerability profile to formulate general conclusions and to elaborate on the potential for existing or prospective policies to remedy the threats, in whole or in part.

Unfortunately, it was not possible to include other data sources that would have been useful. Interviews with active or convicted securities violators or criminals, for instance, and the operational data held by the police or regulatory bodies would have provided useful insights. The reader should be aware of other limitations with respect to the data collection available for this report. The prosecution of criminal organizations in Canada continues to be dominated by drug cases, which interviewees suggest may account for the vast majority of prosecutions under section 467. The first criminal organization and fraud conviction in Canada occurred in 2011

and this decision is apparently under appeal (La Reine c. Construction Exékut 2011). There appears to be one criminal organization and securities case in Canada for which charges were laid in 2011 (*La Presse* 2011). It is clear that the data currently available is insufficient to empirically distinguish between the vulnerabilities for crime/criminals and organized crime/criminal organizations in the securities sector.

Following on from the methodology overview presented above, we would like to provide readers with some additional information concerning interviews for this project that were conducted with twenty (N=20) stakeholders. All interview subjects were provided with the following information and questions immediately below in reduced font and double-indented from the main body of this text, for ease of reference.

Purpose
Public Safety Canada has hired Compliance Strategy Group to examine the extent to which organized crime has penetrated the securities sector and to identify those features of this sector that make it vulnerable to such penetration. By organized crime, we mean groups of at least three persons that commit crimes for profit on an ongoing basis. Please note that use of the term organized crime in this context is a synonym for criminal organization, as defined in Section 467.1 of the Criminal Code of Canada, and the terms are used interchangeably. By vulnerability, we mean a weakness of the securities sector that allows for organized crime penetration or features that make securities attractive to organized crime.

The project focuses on two Canadian jurisdictions as the centres of their provincial securities activities: Montreal and Toronto. One aspect of the project is interviews with key stakeholders and this is why we are interviewing you. For the purposes of the project securities are defined as fungible, negotiable instruments representing financial value. Securities are broadly categorized into debt securities (e.g., bonds, banknotes and debentures) and equity securities (e.g., common stocks, derivatives, futures, options).

The questions below are derived from a review of the available research literature, and the questions are oriented to build upon existing published knowledge in this area.

Confidentiality
Please note that we will not reveal your identity to anyone, other than to state your occupation and employer in generic form.

Questions on the Securities Sector

What types of organized crime groups do you know or suspect are involved in schemes in Ontario and Québec securities markets? Do these groups specialize in particular schemes or general activities, please provide examples where possible.

• Outlaw Motorcycle Gang • Aboriginal-based Organized Crime Group • Italian-based Organized Crime Group (Traditional Organized Crime) • East European-based Organized Crime Group • Chinese or Japanese-based Organized Crime Group • South Asian-based Organized Crime Group	• Other Asian-based Organized Crime Group • Caribbean Organized Crime Group • South American Organized Crime Group • Middle Eastern Organized Crime Group • Affiliated Street Gang • Unaffiliated Street Gang • Other Organized Crime Groups...(Please Specify)

Which types of schemes involving organized do you believe are the most prevalent in the Ontario and Québec securities markets? Please highlight examples that would meet the definition of organized crime above, or examples that may involve participation in or the commission of indictable offences for a

criminal organization, or instructing the commission of an offence for a criminal organization (e.g. individual brokers, or third party professionals such as accountants, lawyers, etc.) :

- Pyramid or Ponzi investments
- Fraudulent high-yield investments (pump and dump)
- Illicit offshore investments
- Affecting a public securities market through fraud or deceit
- Manipulating transactions to give a misleading market value
- Insider trading and tipping others with such information
- Gaming through verbal or written contracts without intention of acquiring or selling shares
- Collusion of brokers/third party professionals
- Other....(Please specify)

Which type of securities investment pose greater risk of organized crime penetration and are there in place similar or different levels of regulation and control with respect to the following contexts: Canadian residents investing in domestic securities **OR** the same group investing in foreign securities **OR** non-resident investments in Canadian securities? Please provide examples and explanation where possible.

Which of the following securities violations would you characterize as representing the greatest risk for organized crime involvement? Which of the following violations are most likely to result in suspected money laundering reports (STRs) to FINTRAC and/or referral to law enforcement including the Integrated Market Enforcement Teams or IMETs?

- Inappropriate personal financial dealings
- Gatekeeper functions
- Handling of client accounts
- Theft, fraud, falsification or misrepresentation
- Supervision
- Undisclosed conflict of interest
- Suitability of investments and leveraging of clients and their accounts
- Off-book or unauthorized/discretionary transactions
- Inadequate books and records
- Trading without appropriate registration
- Other...(Please specify)

Are the regulations, compliance frameworks, and enforcement systems capable of deterring and detecting organized crime involvement in securities markets in Ontario and Québec? Does this capability vary with respect to activities occurring in the following contexts (please explain why the risks may be similar or different):

- Large capitalization brokerages (including the big bank brokerage firms)
- Medium capitalization brokerages
- Small capitalization brokerages
- Unlicensed broker and brokerage activities (e.g. boiler rooms)

Are there particular industry trends that you would highlight as increasing or decreasing the risk of organized crime penetration of securities markets in Ontario and Québec (e.g. growing individual access to trades and trading data through online brokerages and over-the-counter facilities or OTC)?

How would you characterize the effectiveness and efficiency of the system of regulation and control of the securities market in addressing known or potential vulnerabilities to organized crime involvement given the roles and interaction of the following parties:

- Securities Regulators (Ontario Securities Commission or OSC, Autorité des marchés financiers or AMF)

- National and Provincial Self-Regulatory Organizations or SROs (Investment Industry Regulatory Organization of Canada or IIROC, Mutual Fund Dealers Association of Canada or MFDA, and the Chambre de la sécurité financière or CSF)
- Financial Transactions and Reports Analysis Centre of Canada (FINTRAC)
- Law Enforcement including the Integrated Market Enforcement Teams or IMETs
- Crown Prosecutors

What suggestions for improvement would you make to reduce organized crime involvement or the vulnerabilities for such involvement within the securities sector? Please explain:

- Education (industry, public)
- Regulatory changes
- Criminal law changes
- Civil law changes (application or enhanced use of provincial asset forfeiture)
- Interagency coordination
- Other.... (Please specify)

Are there any other matters we have not discussed that you would emphasize as important in understanding the vulnerability to organized crime in the securities market and the potential to reduce and prevent such risks?

THANK YOU FOR YOUR ASSISTANCE TODAY.

Approximately two-thirds of the interviews were conducted over the telephone to accommodate the availability of interviewees/interviewers and the fact that a number of stakeholder groups are based in various jurisdictions. In all the interviews, it soon became apparent that our (literature-based) questionnaire requested a level of detail or granularity of information that was simply not available in the Canadian context. Respondents were generally pleased with the interest and focus of the study, and demonstrated a willingness to be frank and forthcoming with information and assessments on the existing state of knowledge and future prospects. Some respondents were very forthcoming with their comments and provided detailed information.

Respondents did express concerns as to the information that would be collected and how it might be used in the report. A consistent theme involved concerns about respondents or any other parties applying the label "organized crime" or "criminal organization" to particular entities or individuals associated with specific examples. Interviewees noted the lack of securities-related organized crime prosecutions and thus the absence of Canadian court decisions affirming the application of such labels. They urged caution and the avoidance of any application of the criminal organization label to particular examples, given the potential risk of civil action.

Appendix B: Tables

Table 4.1.0 Stock Markets' Significance in the National Economy *(USD billions)*						
	2010*			2009		
Exchange	GDP *(a)*	Domestic Market Capitalization	%	GDP	Domestic Market Capitalization	%
Americas						
Bermuda SE	NA	1.5	-	NA	1.4	-
BM & FBOV ESPA	2,023.5	1,545.6	76.4%	1,574.0	1337.2	85.0%
Buenos Aires SE	351.0	63.9	18.2%	310.1	45.7	14.8%
Colombia SE	283.1	208.5	73.6%	232.4	140.5	60.5%
Lima SE	153.5	103.3	67.3%	126.8	71.7	56.5%
Mexican Exchange	1,004.0	454.3	45.3%	874.8	352.0	40.2%
NASDAQ OMX	14,624.2	3889.4	26.6%	14,119.1	3,239.5	22.9%
NYSE Euronext (US)	14,624.2	13,394.1	91.6%	14,119.1	11,837.8	83.8%
Santiago SE	199.2	341.8	171.6%	161.6	230.7	142.8%
TSX Group	1,563.7	2,170.4	138.8%	1,336.1	1,676.8	125.5%
Asia-Pacific						
Australian Securities Exchange	1,219.7	1,454.5	119.2%	994.2	1,261.9	126.9%
Bombay SE	1,430.0	1,631.8	114.1%	1,236.9	1,306.5	105.8%
Bursa Malaysia	219.0	408.7	186.7%	193.0	289.2	149.9%
Colombo SE	48.2	19.9	41.3%	42.2	9.5	22.6%
Hong Kong Exchanges	226.5	2,711.3	1,197.1%	210.6	2,305.1	1,094.7%
Indonesia Ex	695.1	360.4	51.9%	539.4	214.9	39.8%
Korea Exchange	986.3	1,091.9	110.7%	832.5	834.6	100.3%
National Stock Exchange India	1,430.0	1,596.6	111.7%	1,236.9	1,224.8	99.0%
Osaka Securities Exchange	5,390.9	271.8	5.0%	5,068.9	227.9	4.5%
Philippine SE	189.1	157.3	83.2%	161.2	86.3	53.6%
Shanghai SE	5,745.1	2,716.5	47.3%	4,984.7	2,704.8	54.3%
Shenzhen SE	5,745.1	1,311.4	22.8%	4,984.7	868.4	17.4%
Singapore Exchange *(b)*	217.4	647.2	297.7%	182.2	481.2	264.1%
Taiwan SE Corp.	427.0	818.5	191.7%	378.5	659.0	174.1%
Thailand SE	312.6	277.7	88.8%	264.0	177.0	67.0%
Tokyo SE Group	5,390.9	3,827.8	71.0%	5,068.9	3,306.1	65.2%

Table 4.1.0 Stock Markets' Significance in the National Economy *(USD billions)*						
	2010*			2009		
Exchange	GDP *(a)*	Domestic Market Capitalization	%	GDP	Domestic Market Capitalization	%
Europe – Africa – Middle East						
Amman SE	27.1	30.9	113.8%	25.1	31.8	126.7%
Athens Exchange	305.0	67.6	22.2%	330.8	112.6	34.1%
BME Spanish Exchanges	1,374.8	1,171.6	85.2%	1,467.9	1,434.5	97.7%
Budapest SE	132.3	27.7	20.9%	129.5	30.0	23.2%
Casablanca SE	91.7	69.2	75.4%	91.4	64.5	70.6%
Cyprus SE	22.8	6.8	30.0%	23.6	10.3	43.5%
Deutsche Börse	3,305.9	1,429.7	43.2%	3,338.7	1,292.4	38.7%
Egyptian Ex	216.8	84.3	38.9%	188.0	91.2	48.5%
Irish SE	204.1	60.4	29.6%	222.4	61.3	27.6%
Istanbul SE	729.1	307.1	42.1%	614.5	234.0	38.1%
Johannesburg SE *(b)*	354.4	925.0	261.0%	287.2	799.0	278.2%
Ljubljana SE	46.4	9.4	20.2%	48.6	12.1	25.0%
London SE Group *(c)*	4,295.3	3,613.1	84.1%	4,297.1	3,453.6	80.4%
Luxembourg SE	52.4	101.1	192.9%	52.4	105.0	200.4%
Malta SE	7.8	4.3	55.4%	8.0	4.1	51.0%
Mauritius SE	9.4	7.8	82.2%	8.6	6.6	76.6%
MICEX	1,476.9	949.1	64.3%	1231.9	736.3	59.8%
NASDAQ OMX Nordic Exchange *(d)*	1,072.2	1,042.2	97.2%	1,049.3	817.2	77.9%
NYSE Euronext (Europe) *(e)*	4,010.8	2,930.1	73.1%	4,158.6	2,869.4	69.0%
Oslo Bors	413.5	295.3	71.4%	378.6	227.2	60.0%
Saudi Stock Market – Tadawul	434.4	353.4	81.3%	376.3	318.7	84.7%
SIX Swiss Ex	522.4	1,229.4	235.3%	491.9	1,064.7	216.4%
Tehran SE	337.9	86.6	25.6%	325.9	59.2	18.2%
Tel Aviv SE	201.3	227.6	113.1%	195.4	188.7	96.6%
Warsaw SE	438.9	190.2	43.3%	430.7	151.0	35.0%
Wiener Börse	366.3	126.0	34.4%	382.1	114.1	29.9%
		56,822.1				
Source: IMF website and exchange members						
**2010 GDP data are IMF estimated data; they will be updated next year*						
a – GDP = Gross Domestic Product						
b – Singapore Exchange and JSE market capitalization also include foreign listed companies						
c – London SE Group figures include data from Italy and the United Kingdom						
d – NASDAQ OMX Nordic Exchange figures include data from Denmark, Estonia, Finland, Iceland, Latvia, Lithuania and Sweden						
e – NYSE Euronext (Europe) figures include data from Belgium, France, Netherlands, and the Portugal						
All GDP figures listed at current prices and subject to change.						

Source: World Federation of Exchanges (2011)

Table 4.4.3 Supplementary Tables: MFDA Enforcement Actions for the period July 1 2009 to June 30, 2010

(a) Cases Opened

July 1 to June 30	Total Cases Opened	Escalated to Investigation	Escalated to Litigation
2009-2010	506	96	44
2008-2009	585	100	48
2007-2008	381	109	24
2006-2007	361	130	32
2005-2006	371	117	18
2004-2005	441	98	13
2003-2004	321	44	1
2002-2003	139	8	0

(b) Cases Closed

July 1 to June 30	Case Assessment	Investigation	Litigation	Total
2009-2010	472	46	30	548
2008-2009	350	62	16	428
2007-2008	246	89	26	361
2006-2007	330	83	13	426
2005-2006	266	53	12	331
2004-2005	290	60	3	353
2003-2004	147	9	0	156
2002-2003	97	2	0	99

(c) Active Caseload as of June 30, 2010

June 30	Case Assessment	Investigation	Litigation	All Groups
Atlantic	19	9	3	31
Central	110	72	50	232
Prairie	43	23	13	79
Pacific	33	14	14	61
Canada	205	118	80	403

(d) Disciplinary Action

July 1 to June 30	Cautionary Letter*	Warning Letter*	Agreement and Undertaking*	Notice of Hearing
2009-2010	169**	106	1	26
2008-2009		233	4	31
2007-2008		206	6	19
2006-2007		196	17	21
2005-2006		130	18	10
2004-2005		114	9	9
2003-2004		17	0	0
2002-2003		4	0	0

**Each Case may result in informal discipline to one or more subjects.*
*** Cautionary Letters were introduced in July 2009.*

(e) Cases Opened by Type

July 1, 2009 – June 30, 2010	Number of cases*	Percentage of total
Falsification / Misrepresentation	74	14.62%
Suitability - Investments	57	11.26%
Unauthorized / Discretionary Trading	50	9.88%
Suitability - Leveraging	44	8.70%
Outside Business Activities / Dual Occupation	31	6.13%
Personal Financial Dealings	28	5.53%
Forgery / Fraud / Theft / Misappropriation / Misapplication	24	4.74%
Supervision	24	4.74%
Business Standards	24	4.74%
Policy & Procedures	20	3.95%
Complaint Procedure	19	3.75%
Transfer of Accounts	16	3.16%
Sales Communication	15	2.96%
Commissions and Fees	10	1.98%
Conflict of Interest	7	1.38%
Conduct Unbecoming	6	1.19%
Acting Outside Registration Status	5	0.99%
Trading Outside Jurisdiction	5	0.99%
Referral Arrangements	5	0.99%
Handling of Funds	5	0.99%
Books / Records / Client Reporting	4	0.79%
Financial Requirements	4	0.79%
Provincial Securities Legislation	4	0.79%
Failure to Cooperate	4	0.79%
Excessive Trading / Churning	4	0.79%
Reporting Violations	4	0.79%
Stealth Advising	3	0.59%
Disclosure	3	0.59%
Confidentiality / Privacy	2	0.40%
Securities Regulator‘s Order	2	0.40%
Service Issue	2	0.40%
KYC Documentation Deficiency	1	0.20%
Total	506	100.00%

(f) Cases Opened by Source

July 1, 2009 – June 30, 2010	Number of cases	Percentage of total
METS	229	45.26%
Public	186	36.76%
CSA and Other Regulators	38	7.51%
MFDA Sales Compliance	24	4.74%
Member	14	2.77%
Media	6	1.19%
Other	5	0.99%
MFDA Financial Compliance	4	0.79%
Total	506	100.00%

(g) Cases Closed by Reason

July 1, 2009 – June 30, 2010	Number of cases	Percentage of total
No Violation Established	210	38.32%
Cautionary Letter(s) Sent	169	30.84%
Warning Letter(s) Sent	106	19.34%
Referred To Other Enforcement Case	20	3.65%
Hearing - Settlement - Violation Established	13	2.37%
Under Review by Outside Agency	10	1.82%
Referred – Issues outside MFDA jurisdiction	8	1.46%
Hearing - Violation Established	6	1.09%
Suspension of Membership	1	0.18%
Referred to other MFDA Department	1	0.18%
Referred - Other	1	0.18%
Member Resolution Satisfactory	1	0.18%
Hearing - No Violation Established	1	0.18%
Agreement and Undertaking	1	0.18%
Total	548	100.00%

(h) METS Events Reported

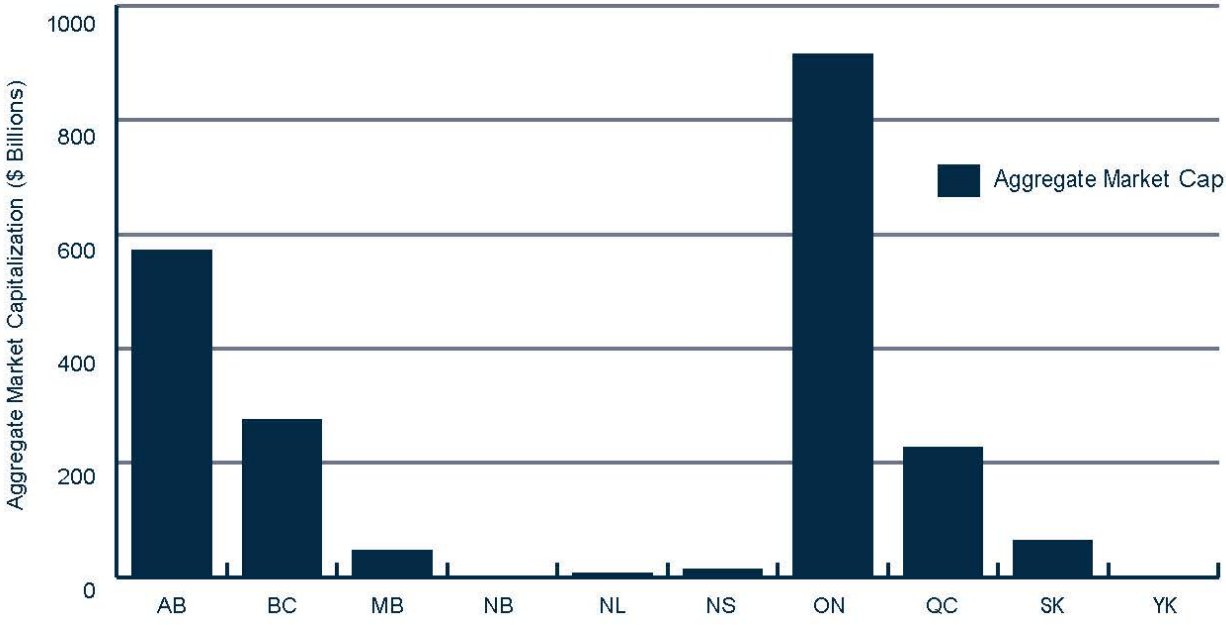
July 1 - June 30	Total Events Reported*
2009-2010	2538
2008-2009	2973
2007-2008	1964

**Numbers may change as a result of updates made to the system*

Source: (MFDA, 2011)

Appendix C Figures

Figure 4.1.0: Distribution of Aggregate Market Capitalization by Province



Source: Alberta Securities Commission, 2011