

***Big Brother in a Brave New World:
Reflections on the potential use and abuse of OSC proceedings in other
forums***

**Brave New World: Securities Litigation & Enforcement
Ontario Bar Association
February 26, 2003**

**Joseph Groia
Kellie Seaman**

**Groia & Company
Lawyers
The Sterling Tower
372 Bay Street, Suite 1000
Toronto, Ontario
M5H 2W9**

**Phone: (416) 203-2115
Fax: (416) 203-9231**

Where to elect there is but one, 'tis Hobson's choice -- take that or none.

Thomas Ward

If there is one simple truism that can be observed in the current state of Canadian capital market psychology it is this: risk tolerance is down, way down, and falling. And predictably so. As the Canadian markets have evolved, the threshold for investing, traditionally reserved for those investors who were 'in the money', has fallen. In turn this has led to an unprecedented sensitivity to market losses. The bottom line is that many of today's investors cannot *afford* to lose and if they do someone needs to be held accountable. In the result, the vast majority of individual market participants, particularly brokers, find themselves not only in a position of difficulty, but one riddled with numerous ways that they can be found liable. This uncertainty is due, in large part, to the proliferation of forums in which matters relating to the same conduct can be prosecuted. Let us consider briefly a broker, allegedly involved in a front-running scheme, as an apt example.

An allegation of front-running – that is a trade in a security by the sale or purchase by a broker, after soliciting his or her clients order to buy or sell the same security but before completing the client's trade – is a serious one. In these cases the broker will inevitably trigger some, if not all, of the following responses: an internal investigation by the compliance department of the brokerage house; external investigations by the applicable self-regulatory organizations (in Ontario this would be the Investment Dealers Association (IDA) and the Toronto Stock Exchange (TSE)); a regulatory investigation by

the Ontario Securities Commission (OSC) to usually be followed by administrative, quasi-criminal or even criminal proceedings; and finally, a host of civil actions brought by the clients harmed by the scheme because they overpaid for their purchase or received less on their sale.

At first glance this case study raises concerns about the potential for a multiplicity of proceedings. However, such concerns only begin to expose the potential difficulties with the process in Ontario. As Murdoch and Brockman explain, situations such as this have “led to concern not only about multiple proceedings (should anyone have to face their accuser in six different arenas?), but also to a concern over how the various agencies share information and evidence and the impact they might have on one another’s decisions.”¹ This is exceedingly important where the rules by which the various regulators operate diverge in respect of their powers of investigation and their ability to use the evidence discovered in that process.

In Ontario, for the moment, the regulatory powerhouse in the market protection business is clearly the Ontario Securities Commission (OSC), and so it is here that the mechanisms for investigation and enforcement are the greatest. In very general terms the object of this paper is to examine the processes of the OSC with an eye to the common uses, and potential misuses, of those processes by other parties in subsequent or collateral proceedings. In particular, using our broker example, we hope to provide some insight into the issues that arise from the investigatory powers of the OSC (and the use that can

¹ Caroline Murdoch and Joan Brockman, “*Who’s on First? Disciplinary Proceedings by Self-Regulating Professions and other Agencies for “Criminal” Behaviour,*” (2001) 64 Sask. L. Rev. 29.

be made of the information gleaned from those exercises), its powers of settlement, and the impact or influence of its decisions and orders, upon subsequent civil actions against individual market participants. But first the story of Hobson.

A Hobson's Choice.

The legend of Tobias Hobson, immortalized by the phrase in his honour and, subsequently, in the writings of the venerable poet John Milton, dates back to the 16th century. As the owner and operator of the only passenger coach service between London and Cambridge, Mr. Hobson rented his horses out in a very orderly manner: each customer was given the 'choice' to rent only the horse that was nearest the stable door. His motivations, so the story goes, were twofold – fairness to the customer (no opportunity to select better horses for some than for others) and fairness to the horse (the system of rotation operated so that the most rested horse was up next for hire). Anyone who objected to this system was free, quite literally, to walk. Thus, the origin of the term 'Hobson's Choice' which has come to be synonymous with having no choice at all.

It is arguable, and we ask that you keep this suggestion in mind as you consider the rest of this paper, that many of the options currently presented to market participants accused of running afoul of the rules, are little more than a Hobson's choice. This is especially so during the investigatory and settlement stages of OSC process and even more so now in light of the new administrative penalty powers of the Commission under the soon to be in force (we fear) Bill 198. There is real reason for concern here – not only is there the

potential for undue pressure on an accused to cooperate and participate without any real option to choose to do otherwise but, more importantly, because the assistance they ultimately give ‘voluntarily’ to the Commission may be used against them in another forum. The suggestion here is not so much that the Commission needs to be addressing these issues with the parties, as it is with defence counsel who should be weighing these considerations when advising their client’s about what is in their best interests. We will highlight these considerations as we make our way through various selected OSC processes.

Defining the Role of the OSC.

An understanding of the powers and procedures of the OSC requires at least a brief consideration of the source of its authority; its ostensible purposes, and the sorts of mischief it is intended to tackle. As a regulatory agency and a creature of statute, the Commission is limited by the confines of its legislation. These objects are prescribed by legal restraints under administrative law and under the Ontario Securities Act (OSA): the latter containing both substantive legal provisions and procedural mechanisms while the former consists of mainly procedural considerations via the Statutory Powers and Procedures Act (SPPA) and the administrative principles of natural justice and procedural fairness.

The Ontario Securities Act, which has as its primary goals the protection of ‘investors from unfair, improper or fraudulent practices’ and the fostering of ‘fair and efficient

capital markets and confidence in capital markets'², contains a detailed 'principles' provision from which the particular concerns the Act is trying to address can be discerned.³ These include the classic disclosure-type and market integration-oriented considerations as well as specific references to cooperation with recognized self-regulatory organizations and administrative efficiency concerns.

The Act undoubtedly provides some insight into the methods and motivations of the Commission, however, it should not be taken to be exhaustive in these respects. The Securities Act, like the capital market it seeks to protect, does not exist within a vacuum. Heightened calls for Commission participation in the current frenzy for enhanced corporate governance and accountability (which are arguably matters best handled by corporate law) provide one example. Although the capital markets are clearly impacted by boardroom activities, corporate governance issues are distinguishable from securities issues and yet the perception exists that any apparent legislative gap, intended or otherwise, can be bridged by a broad interpretation of Commission 'purposes' and/or 'principles' and/or the 'public interest'. We will see this broad and overly generous interpretation of the Securities Act again and again in our discussion of the powers and procedures of the OSC. But for now it is enough just to appreciate the unique position of the Commission in Ontario's capital markets as we examine, a little more closely, the Commission process.

OSC Investigations and Examinations: A Broad and Unusual Power.

² *Securities Act* (Ontario), R.S.O. 1990, c. S. 5, s. 1.1.

³ *Ibid.*, s.2.1.

The powers of investigation and examination bestowed upon Staff of the Commission are not only extensive but they are, at least according to Staff, also extraterritorial in scope. Pursuant to section 11 the Commission may order ‘such investigation with respect to a matter as it considers expedient’ in the administration of securities law and the regulation of the capital markets, not only within Ontario, but ‘in another jurisdiction.’⁴ We believe that the time is neigh for these limits to be challenged – not necessarily in Ontario but in that other jurisdiction where the OSC will have no home court advantage and, at best, can hope for some form of muted judicial deference.

The scope of investigation (again according to Staff) is just about as wide. Commission staff may investigate and make inquiries into the affairs of persons and companies, including their trades, communications, negotiations, transactions, assets and the control thereof; may examine documents and/or things in the possession of those persons and/or companies or any other persons or companies; and, may summon and enforce the attendance of any person and to compel that person to testify on oath under the threat of contempt by the Ontario Court (General Division) ‘as if in breach of an order of that court.’⁵ This is significant in that stands it stark contrast to the right of silence extended to persons under investigation in the non-regulatory context.⁶ Madam Justice Molloy of the Ontario Superior Court of Justice acknowledged this when she said “the power of the

⁴ Ibid., s.11(1)(a) & (b).

⁵ Ibid., § 11(3)(a) & (b), 11(4), 13(1).

⁶ The Supreme Court of Canada acknowledged that it is a time-honored fundamental principle that a person under investigation can decline to speak to the authorities: *R. v. Hebert* [1990] 2 S.C.R. 151.

Commission to compel a person to come forward and give statements under oath relating to an investigation is a broad and unusual power.”⁷

Needless to say, it is clear that there are numerous potential problems inherent in such wide reaching investigatory powers. However, even those who are not well-versed in the fine points of an accused’s rights should, at the very least, have a nagging sense of uneasiness and a strong sense that surely the Canadian Charter of Rights and Freedoms (the ‘Charter’) must, somehow, play a role in this. They would, of course, be right on both counts. However, the OSC is a regulatory body and this has, apparently, made a difference up until now.

The Role of the Charter in the Regulatory Context.

The most significant potential Charter implications of overreaching investigatory powers lie in sections 7, 8 and 11 of the Charter. These include the right to life, liberty and security of the person, the right to be secure against unreasonable search and seizure, and a bevy of other protections extended to those persons ‘charged with an offence’ (including the right to be presumed innocent until proven guilty and the right to be informed of the offence one is charged with). However, Canadian courts have articulated what amounts to exceptions based upon the predominant purpose of the investigation and the legitimacy of one’s privacy expectations. In turn, each of these justifications for attenuating Charter protections derives from the self-professed and then judicially-endorsed ‘protector’ role of the OSC. This is exemplified by the finding of the Supreme Court of Canada that the

⁷ *Coughlan v. WMC International Limited* [2000] O.J. No. 5109

focus of regulatory law should be the protection of societal interests, not the punishment of an individual's moral fault.⁸

Purpose and Expectation: Justifications for Attenuating Charter Protections.

The Supreme Court of Canada tackled the potential Charter implications of regulatory investigations in *British Columbia Securities Commission v. Branch*.⁹ This case involved the issuance of subpoenas by the British Columbia Securities Commission requiring senior officers of a company to testify and produce documents. The authority of the British Columbia Commission to make such orders was contested on the basis that the information obtained in the hearing would be made publicly available. The Supreme Court rejected this proposition relying on the decision of La Forest J. in *Thomson Newspapers* that ‘the degree of privacy the citizen can reasonable expect may vary significantly depending upon the activity that brings him or her into contact with the state.’¹⁰

In respect of securities specifically, Iacobucci J. said that “persons involved in the business of trading securities do not have a high expectation of privacy with respect to regulatory needs that have been expressed in securities litigation.”¹¹ So long as the ‘predominant purpose’ of the Commission is for some proper public purpose Charter

⁸ *R. v. Wholesale Travel Group Inc.* [1991] 3 S.C.R. 154.

⁹ [1995] 2 S.C.R. 3.

¹⁰ *Thomson Newspapers Ltd. v. Canada (Director of Investigation and Research, Restrictive Trade Practices Commission)* [1990] 1 S.C.R. 425 at 506.

¹¹ *Branch*, above note 1, at 39.

protections will to some degree be subordinated to this purpose. In *Branch* the Court found the requisite public purpose in the regulation of the securities market.

Not surprisingly, the OSC also views itself as always operating within the predominant purpose test. In *YBM*¹² the OSC had this to say about investigation orders made pursuant to s. 11 of the Securities Act:

The predominant purpose of the section 11 investigation order is to serve a legitimate public interest: to investigate violations of the Act, which is essentially a scheme of economic regulation to discourage detrimental forms of commercial behavior.¹³

That is of course arguable. However, surely there is a limit on the lengths to which Courts will go in the name of ‘legitimate public interest’. By analogy, is it not also in the public interest to keep accused murderers off the street? And yet we do not entertain suggestions of attenuating Charter protections in the criminal context. Or do we? It will be interesting to see how the Supreme Court of Canada decides the Charter challenges that are sure to arise in securities cases once the changes wrought by Bill 198 are implemented. In particular, our concerns here lie in the new ‘administrative fines’ provisions, which we suggest walks like, looks like and quacks like penal consequences, of up to \$1 million under their ‘public interest’ discretion in s.127 of the Act.

The use of information obtained by the Commission in subsequent civil actions.

¹² *Re YBM Magnex International Inc.* (2001) 24 O.S.C.B. 1961.

¹³ *Ibid.*

For the purposes of this paper the most problematic aspect of this open arms approach to regulatory investigations arises vis-à-vis the potential use that can be made of the information acquired by the OSC under s.11. In particular, the disclosure provisions in the Act allow the Commission to make the nature and content of the investigation order and the examinations known ‘to any person or company’ so long as it is ‘in the public interest’ to do so.¹⁴ A recent decision of the OSC provides a telling example.

In *Coughlan v. WMC International*¹⁵ the Commission ordered the disclosure of transcripts of evidence and related documents obtained pursuant to an investigation order by the Commission. The applicant sought production of this material for use in its defence in an ongoing civil proceeding in Nova Scotia. The OSC, in a 2:1 decision, ordered the disclosure on public interest grounds. Interestingly, the public interest concern in this case was the preservation of the integrity of the OSC – the case involved allegations that the OSC did not act independently in exercising its discretion to commence proceedings against Mr. Coughlan.

The decision was not upheld on appeal, at least in part, because of the lack of procedural protections in place.¹⁶ However, the decision of the Ontario Court of Justice in *Consolidated NBS Inc. v. Price Waterhouse*¹⁷ finds that once a party has received documents from the OSC those documents will not be privileged. In this case parties to a civil action sought disclosure of documents generated by the OSC during its

¹⁴ *Securities Act* (Ontario), s. 17(1).

¹⁵ (2001) 24 O.S.C.B. 287

¹⁶ *Supra*, note 7.

¹⁷ [1994] O.J. No. 263.

investigation. It was held that although ‘any documents generated as a result of the investigation of the Securities Commission are protected by the wording of s.14 [the ‘Evidence not to be disclosed’ provision] and need not be disclosed ... all documents received from the Securities Commission are subject to production.’¹⁸

Any post-investigation protection that may be offered to market participants by privilege of Commission documents is, in any event, negligible. Especially given that the information obtained during the investigation is the foundation for the Notice of Hearing and the statement of allegations, both of which not only form part of the public record but are published in OSC bulletins and on its website.¹⁹ The threat of adverse publicity brings us to another feature of the Commission process that is ripe for use and abuse: the settlement process.

Settlement with the OSC: Some Considerations.

The procedure for settlements between OSC Staff and OSC respondents is set out in the Practice Guidelines to the Ontario Securities Commission Rules of Practice.²⁰ But before we get to the actual provisions we would like to take a moment to review the needs that cause the Commission and respondent alike, to settle. The advantages of settlement are largely the same irrespective of which side of the regulatory fence one is sitting on. For example, settlements will, in most cases, be faster, cheaper and more flexible. In our experience, generally speaking faster is better in OSC matters and, thus, little

¹⁸ Ibid.

¹⁹ Have a look at <http://www.osc.gov.on.ca>.

²⁰ Practice Guidelines, Settlement Procedures in Matters Before the Ontario Securities Commission, Rule 9.

consideration of this advantage is required. In respect of ‘cheaper’ the Commission’s interests here are borne out in the administrative efficiencies associated with saving hearing time and preparation by Commission Staff. For the respondent these same considerations are reflected in legal costs. However, the considerations diverge in two important respects: predictability and publicity.

It is arguable that the ability to predict the outcome of proceedings acts as greater encouragement to settle for the respondent than it does for the Commission. This assertion is based in part on the admonition by the British Columbia Securities Commission that settlement sanctions are usually lighter than those which Staff would ask for at a full hearing and there is a greater range of alternative solutions available in the settlement context than in a hearing.²¹ Given this caveat it is not hard to get a sense of the temptation to negotiate a settlement with the Staff of the Commission. Add to this the threat of a full-blown media frenzy surrounding the publication of the Notice of Hearing and we begin to see the choices available to the respondent for what they really are – no choice at all.

The publicity surrounding the Notice creates an additional, less obvious, risk to respondents in that it increases the odds of having to face civil actions by making potential litigants alive to the liability issues. This, too, clearly impacts on the decision-making ability of a respondent and it is here where the greatest settlement-imposed risks lie. We will canvass this more fully in the context of using settlement agreements in civil

²¹ British Columbia Securities Commission Notice “*Settlements with the British Columbia Securities Commission*” November 17, 1989.

actions. For now it is enough to know these concerns are very real as we turn to the nuts and bolts of negotiating settlements with the OSC.

Settlement Agreements: Procedure, Content and Timing.

Generally speaking, the ‘option’ to settle is always open to the respondent and it is the respondent’s place to request settlement discussions.²² The guidelines actually create two streams of Commission approval depending upon the timing of the agreement. Where the agreement is by way of joint recommendation and is reached before a Notice of Hearing is issued, Staff of the Commission may settle with a respondent with the consent of the Executive Director.²³ However, where the agreement is only as to facts or occurs after a Notice of Hearing has been issued, approval by a panel of the Commission is required (unless the Notice of Hearing is withdrawn by Staff).²⁴ Interestingly, if the proposed settlement agreement is only as to facts and the timing is such that a Notice of Hearing has not been issued, the guidelines provide for one to be issued. This prohibits a respondent from entering an agreement only as to the facts (without admitting wrongdoing) in order to avoid the publicity associated with the issuance of a Notice of Hearing.

With respect to content, the guidelines are clear: it must be in writing and should contain among other things, a full account and accurate statement of the relevant facts admitted

²² Practice Guidelines, 2 (1): ‘The Commission will enter into and carry on settlement discussions with a respondent ... where staff is of the view that in the circumstances an appropriate result may be achieved by doing so.’

²³ Practice Guidelines, 1 & 5 (1).

²⁴ Ibid.

by the respondent, a joint recommendation on remedial orders to be imposed by the Commission, a waiver by the respondent of a full hearing and judicial review and appeal rights, and an agreement by Staff and the respondent not to make public statements that are inconsistent with the settlement agreement.²⁵ Be wary here, however, as inconsistency lies in the eye of the beholder and the OSC Staff has an unfortunate tendency to be flinty eyed about comments post-settlement.

One final point of interest that needs to be considered for settlement agreements is when and how they are published. Pursuant to the guidelines ‘after a proposed settlement is approved by the Commission, the settlement agreement and any related order will be published in the OSC Bulletin.’²⁶ This creates the unfortunate situation that no matter how a respondent tries to avoid it, the adverse publicity - dreaded not only for its potential damage to reputation but more importantly for its potential to instigate additional litigation - will be unavoidable. To make matters worse, whereas the findings of a panel, subsequent to a hearing, provide the respondent with a continuing opportunity to dispute the allegations, a settlement agreement is akin to an admission of guilt. The significance of this in the context of subsequent civil actions cannot be overemphasized.

The use, or rather abuse, of OSC settlements in civil actions.

One of the fundamental principles of settlement is that of settlement privilege. This principle holds that negotiations and agreements are privileged irrespective of whether or

²⁵ Ibid., 4 (1) (a), (b), (f) & (g).

²⁶ Ibid., 7 (1).

not a settlement is reached. There are, however, exceptions. Much as one might be tempted, no matter how foolishly, to think that the Canadian Charter of Rights and Freedoms may apply to Commission powers of examination, one might likewise believe that this settlement privilege applies to settlements with the Ontario Securities Commission. Sadly, it does not.

*Hill v. Gordon-Daly Grenadier Securities*²⁷ is a decision of the Ontario Superior Court of Justice holding that settlement privilege does not apply to settlements with the OSC. The crux of the decision lies in an important distinction drawn between the legitimate expectations of civil litigants and those (we suggest) illegitimate expectations of persons involved in proceedings before the Commission. This expectation-based argument is reminiscent of those considered by the Supreme Court of Canada in *Thomson Newspapers*²⁸ and *Pezim*²⁹ for of privacy expectations. Not surprisingly, the effect is also the same – a legal right, thought to be fundamental, has been compromised, presumably in the name of administrative efficiency and specialized expertise.

To make matters worse the courts have held that a settlement is tantamount to a guilty plea (*Gordon-Daly*³⁰) and a guilty plea is clearly admissible so long as the parties are the same: *Re Charlton*.³¹ Incidentally, the court in *Gordon-Daly* found that the parties in a Securities Commission proceeding were one and the same as those in a subsequent class

²⁷ [2001] O.J. No. 4181.

²⁸ *Supra*, note 10.

²⁹ *Pezim v. British Columbia (Superintendent of Brokers)* [1994] 2 S.C.R. 557.

³⁰ *Supra*, Note 25.

³¹ [1969] 1 O.R. 706.

action proceeding on the basis that the plaintiff's were also the complainants that gave rise to the proceedings at the Securities Commission. Remarkable.

Back to the Broker.

In our earlier example, a broker suspected of front-running, was investigated by the OSC. Subsequently, this broker 'decides' to cooperate with the Commission because the legislation says he will or he won't like the consequences. Post-investigation, but pre-Notice of Hearing, the Commission determines that the broker isn't in quite deep enough. But maybe, just maybe, he knows who is. So they say 'let's strike a deal'³². The Broker admits he committed some wrongdoing so the Commission will approve the settlement agreement (remember the guidelines say that in order for a settlement agreement to be approved pre-Notice of Hearing, without a subsequent publication of a Notice of Hearing, the agreement must be a joint recommendation, i.e. not merely an admission of facts) while cooperating so as to save his soft broker hide.

Unfortunately for the broker, the publicity surrounding the allegations against the brokerage house has generated considerable interest amongst litigation-savvy clients past and present. An action or class action is commenced and the settlement agreement with its admissions of wrongdoing, entered into by the broker is now the strongest evidence against him.

³² The Ontario Securities Commission announced its 'Credit for Cooperation' policy in a news release dated April 9, 2002. This allows market participants to benefit from cooperating with Staff during an investigation by, inter alia, blowing the whistle on their fellow market participants.

The likelihood of brokers and other individual market participants finding themselves in such undesirable positions is increasing due to two rather recent trends: increased accessibility to class proceedings³³ and increasing powers of regulatory authorities. In respect of the latter, the passing of Bill 198³⁴ in December 2002 will undoubtedly impact on the viability of ‘choosing’ not to settle with the Commission. How many individuals (or companies for that matter) are going to risk a Commission hearing, pursuant to s.127 of the Act, in light of the fact that the Commission will have the power to levy fines of up to \$1 million dollars? We suggest these new punitive powers will substantially increase the ‘settlement factor’ of the Commission in much the same way as strike suits have encouraged settlements in class actions.

Back to Hobson.

Having heard the story of Hobson one might make the observation that it is rather unfortunate that a man who dedicated his life to his business (ultimately failing due to the outbreak of the Plague) and the fair treatment of his customers (and horses), is known, five centuries later, not for his insistence on fairness but rather for his failure to provide a choice. We suggest there is a moral lesson here. The ability to negotiate a real settlement with a Securities Commission is a good thing. And the procedural and economic advantages of early settlement are substantial. However, the opportunity to

³³ The following Canadian provinces currently have class proceedings legislation: Ontario, British Columbia, Saskatchewan, Newfoundland and Labrador, and Quebec. In addition, the Alberta Law Reform Institute published its Final Report in December 2000 recommending the enactment of class action legislation in that province. More importantly, however, in *Western Canadian Shopping Centres* [2001] 2 S.C.R. 534 the Supreme Court of Canada essentially filled the procedural vacuum in provinces without class proceedings legislation by empowering ‘the courts [to] fill the void under their inherent power to settle the rules of practice and procedures as to disputes brought before them.’

³⁴ This Bill is not currently in force.

reach a settlement is only a fair one if the opportunity to choose to do otherwise is equally real. Once a respondent is positioned in such a way as to preclude any course of action other than agreeing to settle, no longer do you have a 'settlement'. Instead what we are left with is a decision, extracted by the Commission Staff, under the guise of an agreement. And that, like Mr. Hobson's, is no real choice at all.

It took the plague to bring real change to Mr. Hobson's business. Let us all hope that something less than a regulatory plague will do the same for the OSC.