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Self-regulation in the Canadian securities industry: Funnel in, funnel out, or funnel away?

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Abstract

The study analysed the processing of complaints against investment brokers and Dealer Members through the Investment Dealer Association (IDA) of Canada's disciplinary system between 2002 and 2007. The cases processed are discussed in relations to a misconduct funnel that examines the IDA's claim that it brought more complaints into the disciplinary system (funnel in), and shows how these complaints were reduced once they entered the system (funnel out), and deflected away from the criminal justice system (funnel away). The results indicate that the IDA was ineffective in disciplining its members because it was unable to handle the more serious and systemic industry problems. To respond to its impossible mandate, the IDA was involved in symbolic management to create a well-crafted image for public consumption of its effectiveness, notwithstanding its inability to do so in practice. The results further increased the call for cross-disciplinary research on securities market regulation.

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1. Introduction

Beginning in 2007, the world was shocked by a stock market crash that sent major indices (such as the S&P 500 and the MSCI Index) tumbling. The resulting effect was that investors'

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portfolios shrank in value, and many asset management firms went into survival mode, while others went out of business. Apropos with the financial crisis, leading financial regulation experts and industry professionals alike blamed the failure on the policies related to self-regulation (Credit Suisse, 2012: para. 1; CFA, 2013: 3). Former Securities and Exchange Commission's (SEC) Chairman, Christopher Cox, conceded that self-regulation of the investment banks contributed to the crisis (Labaton, 2008: para. 1–4). Some even go as far and argue that the “financial crisis resulted from the largely unregulated nature of global financial institutions” (Engobo et al., 2009: 230). While it is difficult to dispute these claims, some degree of introspection is needed to address these assertions of regulatory failure by SROs operating in the securities industry. Framed in relation to the global financial crisis (GFC) of 2008 and the widespread concerns regarding the ineffectiveness of self-regulation in the securities industry, this study seeks to examine the enforcement practices of one such SRO: the Investment Dealers Association of Canada (IDA).¹ The IDA was the national SRO that was responsible for policing investment dealers and their respective Member firms that traded on the debt and equity marketplaces in Canada. The IDA was responsible for setting its own education standards and regulatory requirements. Investment dealers and their respective entities were expected to comply with the IDA's rules, or face sanctions ranging from fines to permanent bans from the Association for non-compliance.

On the basis of an analysis of published data, this study will utilize the SRO's misconduct funnel as it was developed by Brockman and McEwen (1990), and further refined by Brockman (2004), to examine the enforcement of complaints by the IDA for six years (2002–2007) leading up to the GFC. Brockman and McEwen (1990) and Brockman (2004) modified the crime funnel that was initially developed in order to show how the number of cases involving street crimes shrank as they were processed from arrest to sentencing through the criminal justice system (CJS), and applied it to examine the disposition of complaints by The Law Society of British Columbia. Brockman and McEwen's model of case disposition by SROs is built on three fundamental concepts: “funnel in”, “funnel out” and “funnel away” (see Brockman and McEwen, 1990; Brockman, 2004).

As can be seen in Fig. 1, “funnel in” tests the claim made by SROs, “that they enforce standards which would not otherwise be enforced” by other government agencies (Brockman and McEwen, 1990: 3). At the center of this premise is the notion that SROs scrutinize a wider variety of behaviours and ensure a higher standard than government regulators (p. 3). “‘Funnel out’ looks at how offenders might escape disciplinary action once they enter the system, and the potential leniency of penalties imposed on those who are formally sanctioned” (Brockman, 2004: 73). The preoccupation of SROs to protect their own, “may function to keep their members from coming into contact with the CJS when criminal offences have been committed” (Brockman and McEwen, 1990: 4). This charge alleges that “SROs ‘funnel away’ individuals from the CJS who might otherwise come into contact with it” (p. 4). By applying the concept of the regulatory “funnel” to the context of professional self-regulation, this study will examine the enforcement practices of the IDA from 2002 to 2007.

It seems rather obvious that SROs will track more complaints than coercive state led enforcement (see Brockman, 1998; Brockman, 2004). The resultant effect is that SROs are more likely to “funnel in” more complaints than would have been handled by the CJS. The

¹In 2008, the IDA (the SRO responsible for regulating investment and brokerage firms in Canada) and Market Regulation Services Inc. (“RS”- the SRO responsible for regulating the marketplace), merged to create the Investment Industry Regulatory Organization of Canada (IIROC).

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