Research Study

Principles and Rules in Public and Professional Securities Law Enforcement: A Comparative U.S. – Canada Inquiry

Lawrence A. Cunningham

May 31, 2006

Commissioned by the
Task Force to Modernize Securities Legislation in Canada

Lawrence Cunningham

Lawrence A. Cunningham is Professor of Law and Business, Boston College, and Associate Dean for Academic Affairs, Boston College Law School. Cunningham has written and published more than 30 scholarly articles and 10 books. These cover a wide range of subjects within the broad domain of business-related law, which includes matters arising in corporate and securities law; accounting and auditing; finance, investing and valuation; contracts; legal ethics; and administrative, insurance, and intellectual property law.

Books include leading teaching books for law school courses in Accounting, Corporations and Corporate Finance as well as general-interest titles. His books and articles have been reprinted or serialized in numerous anthologies and periodicals and have been translated into many languages, including Chinese, French, German, Greek, Japanese, Korean, Portuguese, Spanish, and Russian. They are excerpted or quoted in leading teaching books for law school courses in Accounting, Contracts, Corporations, Corporate Finance, and Professional Responsibility.

Lawrence previously taught at Benjamin N. Cardozo Law School, Yeshiva University, where he directed The Samuel and Ronnie Heyman Center on Corporate Governance. He has served as Visiting Professor at George Washington University and Vanderbilt University. He also has lectured at several other schools and given scores of presentations for a wide range of audiences, including academics and practitioners in both law and accounting and for investors.

Lawrence has served as a consultant to corporate boards of directors, law and accounting firms, and regulatory and standard-setting bodies and has given expert witness testimony in matters concerning corporate governance, valuation, investment and securities regulation. He was Director of the Independence Standards Board's Task Force on Alternative Practice Structures of Auditors from 1998 to 2001.

Before entering into law teaching in 1992, Cunningham practiced corporate and securities law as an associate with Cravath, Swaine & Moore, New York. He is a magna cum laude graduate of Cardozo and earned his B.A. with honors in Economics from the University of Delaware. He was born and raised in Wilmington, Delaware.

Table of Contents

1. Executive Summary

This study investigates the use of rules versus principles in securities law enforcement by public and professional officials in the United States and Canada. Part 3 provides theoretical and conceptual perspectives on the idea of rules and principles in securities laws and how they may influence enforcement. Part 4 investigates empirical and analytical proxies as to enforcement activity and effectiveness by the U.S. Securities and Exchange Commission (SEC) and members of the Canada Securities Administrators (CSA) on the one hand, and the U.S. National Associate of Securities Dealers (NASD) and Canada's Investment Dealers' Association (IDA) on the other.

The study first questions whether it is sensible or possible to devise a system of securities regulation denominated as principles-based compared to rules-based. Rules and principles are imperfect categories to describe laws. While some laws may fit neatly into such descriptions, most blend aspects of each and rational systems of law invariably partake of hybrids running across the continuum from end-to-end. Ambitions to emphasize one or the other abstractly prevent assessing trade-offs that rules versus principles present, chiefly those of certainty versus context and of norms versus novelty.

The study then conceptualizes public enforcement of securities laws along the rules-principles continuum. Numerous sources of information trigger investigations of potential enforcement actions. None of these appears systematically connected to whether an underlying violation assertion hinges upon application of a rules-based law or a principles-based law. Yet regulators occasionally express aspirations for principles-based regimes. For regulators otherwise unable to enforce securities laws absent specific violations of rules, a regulatory move towards promulgating principles can unduly elevate the possibility of enforcement actions bearing an arbitrary quality.

The study proceeds to analyze empirical information concerning enforcement actions by the SEC and CSA. Both slightly favour rules-based enforcement, but a considerable portion of cases assert principles-based violations. As between the SEC and CSA, the SEC exhibits slightly more activity enforcing principles-type laws than CSA members. But, in general, the SEC and CSA show strong similarities in terms of the distribution of actions across subject matters, with important differences plausibly attributable to demographic factors.

An important gauge of enforcement effectiveness is the distribution of cases across all core securities law areas, which neutralizes any enforcement bias in favour of rules or principles. Other effectiveness proxies

include enforcement cases successfully resolved and propensity of respondents to settle, both of which could slightly bias case selection towards rules-based violations rather than principles-based violations.

Finally, the study considers the distribution of actions along the continuum of principles- and rules-based enforcement among professional enforcers - the NASD and IDA. The NASD Manual and IDA Rule Book each spans many hundreds of pages of detailed text. Both are dense compilations of detailed rules that also contain some broad general statements. Despite such heavy articulation of rules, the vast majority of enforcement actions by NASD and IDA assert principles-based violations of commercial honour and conduct unbecoming, respectively. The contrast between NASD/IDA on the one hand and the SEC/CSA on the other may be due to the formers' professional (non-public) character and/or may indicate that the process of producing rules establishes norms whose articulation reduces departure risks and consequences.

Among normative implications, participants should be sceptical of the possibility of establishing a principles-based regime. It may not be feasible and may produce enforcement actions bearing arbitrary qualities. It appears desirable for enforcers to state how they measure enforcement effectiveness, and this likely should include the goal of distributing cases across all core areas. If rule-making and adoption help to instantiate norms and promote ease of compliance, then it is a mistake to discard them, even if it were theoretically possible to shift to a principles-based regime.

The SEC's annual reports identify more elaborate performance measures than CSA does. These are required by the U.S. Government Performance and Results Act of 1993. While resulting reports are not perfect, it could be desirable for CSA members to pursue a more conscious strategy of defining enforcement goals and publicizing results in terms of those goals.

2. Introduction

This study inquires into a series of questions about the use of rules versus principles in securities law enforcement actions by professional and public officials in the U.S. and Canada. Is it sensible or possible to devise a system of securities regulation denominated as principles-based compared to rules-based? What is the relationship between securities laws denominated as principles versus rules to resulting enforcement activity and effectiveness? Does the relative distribution of actions between principles- and rules-based enforcement vary between public and professional enforcers? Does it vary between the U.S. and Canada? What normative implications follow from attempts to answer these questions?

Part 3's theory and overview provides conceptual perspective. First, it inquires into the nature of rules and principles and demonstrates how these complex labels invariably require sorting specific laws onto a continuum rather than precisely fitting into one category or the other (and also recognizing numerous gradations, such as factor tests). It explains how a rational system of securities regulation inevitably contains laws bearing attributes of both rules and principles. Second, it explores the relationship of rules and principles to securities law enforcement activity and effectiveness. This discussion emphasizes the need for analytical rather than purely quantitative assessment devices.[1]

Part 4 looks at enforcement activity and effectiveness arranged according to a schematic of rules and principles. Section i. concentrates on the comprehensive enforcement program of the U.S. Securities and Exchange Commission (SEC) and the fragmented program of members of the Canadian Securities Administrators (CSA). Along the rules-principles continuum, insider trading and market manipulation laws are classified towards the principles-based end and securities offerings and firms towards the rules-based end; disclosure regulation (including accounting) contains a broad mix of principles and rules. Evidence indicates that CSA members and the SEC slightly favour rules-based enforcement, but a considerable portion of cases assert principles-based violations. As between the SEC and CSA, the SEC exhibits slightly more activity enforcing principles-type laws than CSA members. Analytical proxies support the conclusion that neither enforcement program's effectiveness is skewed by the mix of rules or principles in the respective securities laws.

Section ii. of the schematic looks at the U.S. National Association of Securities Dealers (NASD) and Canada's Investment Dealers Association (IDA) in their roles as professional trade associations

[1] *See* Poonam Puri, *Enforcement Effectiveness in the Canadian Capital Markets* (manuscript dated Dec. 1, 2005), at 21-22 (on file with the author).

empowered to make and enforce securities regulations governing member securities firms. This presents data suggesting that both organizations are heavily biased to enforcing principles over rules. The NASD does so by regular invocations of its Rule 2110, requiring commercial honour, and IDA does so by routine invocations of its By-law 29.1 proscribing conduct unbecoming or detrimental to the public interest, along with a steady citation of its regulation requiring due diligence in determining investment suitability for client accounts. These biases towards principles in these enforcement programs exist despite both groups having promulgated elaborately detailed rules. This provides some basis for questioning the effectiveness of these enforcement programs.

The study offers a cautionary perspective on common understandings of comparative securities law enforcement in Canada and the U.S.. It commonly is believed that U.S. securities laws are more rules-based, while Canada's are more principles-based. The current study does not support such a conception. If it were true, moreover, one might expect enforcement activity in the U.S. to be more rules-based than principles-based and Canada to show opposite emphasis. The study does not support this conclusion either.

Instead, the countries' respective securities laws and related enforcement activity by the SEC and CSA members have considerable commonalities (described as mixing attributes of rules and principles in articulation and showing only slightly different enforcement biases as between cases based on violations of rules or principles). Likewise, the NASD and IDA exhibit commonalities. The stronger contrast is between these pairs of public versus professional enforcers, with the latter promulgating elaborately detailed rulebooks and yet running enforcement programs strongly skewed towards principles.

These commonalities and differences exist despite considerable national variance (of economies, capital markets and securities industry), in size, age, depth, regulatory theory and enforcement structures and remedies. The discovery suggests that it is not so much about countries or the underlying written materials as it is about identity and position (public enforcer or professional self-policing).

3. Terms and Theories

Laws may assume characteristics of rules or principles or both, requiring evaluating the nature of rules and principles. Enforcement of those laws can be considered in terms of both activity levels, which are readily observable, and enforcement effectiveness, which, though not observable, can be inferred from analysis. The bearing of rules or principles on both enforcement activity and effectiveness thus also warrants discussion.

i. Law

Laws may be arrayed along a continuum ranging from principles to rules. Such a conception of these categories is necessary because of inherent classification difficulties among such capacious and complex concepts. Debate over classification and relative desirability of articulating law as rules or principles engages a long and rich jurisprudential history.[2] The present discussion cannot justly reflect this extensive literature but will instead highlight aspects of the discourse particularly useful to the study's substantive inquiries.

A classic historical conception is law versus equity. The dichotomy enables balancing between violations of a specific rule with the more general context of norms or facts that might excuse violations. Law laid down the rules and equity enabled their attenuation. Equitable balancing thus accepted that a rule was violated and then considered whether to suspend it, in light of other principles. Equity's jurisprudence of principles contained a broad collection of tools such as laches, estoppel, clean hands, comparative utilities, the adequacy of legal remedies, irreparability, a balance of convenience, and, significantly, consideration of the "public interest."[3] Thus, historically, principles were available to mediate application of rules whose literal enforcement would work hardship.

While equity was historically used as the framework to invoke principles that excuse violation of rules and reject enforcement, natural law sometimes provided principles whose violation would be enforced.

---

[2] John Braithwaite, *Rules and Principles: A Theory of Legal Certainty*, 27 AUSTRALIAN J. LEGAL PHIL. 47 (2002); Cass R. Sunstein, *Problems with Rules*, 83 CAL. L. REV. 953 (1995); Louis Kaplow, *Rules and Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); Pierre J. Schlag, *Rules and Standards*, 33 UCLA L. REV. 379 (1985); Douglas Baird & Robert Weisberg, *Rules, Standards, and the Battle of the Forms: A Reassessment of § 2-207*, 68 VA. L. REV. 1217 (1982); Duncan Kennedy, *Form and Substance in Private Law Adjudication*, 89 HARV. L. REV. 1685 (1976); RONALD DWORKIN, *Hard Cases*, in TAKING RIGHTS SERIOUSLY (1977); HERBERT HART & ALBERT SACKS, THE LEGAL PROCESS (tent. ed. 1958).

[3] *See* Zygmunt J.B. Plater, *Statutory Violations and Equitable Discretion* 70 CAL. L. REV. 524 (1982).

Jurisprudentially, the concepts of rules and principles thus may be seen as akin to the relation of positivism to natural law - positivism and rules are manifest law stated in official pronouncements, while natural law is the imminent understanding of right and wrong, fair or unfair. While such categories can be of great utility in developing a system of justice, they become increasingly hard to recognize in such technical, commercial and policy-laden fields as securities regulation. Here, a background principle of fairness or efficiency may be identifiable and may even resemble an attribute of natural law, but pressure is strong to state clearly the bases for legislative and regulatory policy.

Even so understood as positive law, legislative and regulatory pronouncements may bear attributes either of rules or of principles. This viewpoint enables classifying a securities law as a rule or a principle by describing the process of its articulation and evolution.[4] Suppose that a legislator or regulator proposes a new law consciously expressed as a principle - such as that public companies must continuously disclose all material information concerning their operations and finances. During the public vetting of this proposal, constituents comment on it. Invariably, these comments assume the form of making clarifications or exceptions to the principle.

Clarifications entail assigning meaning to such general concepts as continuous. Is it literally a 24-hour, 7-day concept or are there limitations for evenings, weekends or holidays? Exceptions entail anticipation of likely but not routine circumstances, such as for pending merger negotiations whose premature disclosure would scuttle a beneficial deal. Within the exceptions, moreover, limitations may be anticipated - as when a company in merger negotiations receives a competing bid from another suitor. In such a competitive bidding contest, the calculus changes so that continuous disclosure may be regarded as more important than confidentiality.

Results of such lawmaking exercises are a stated principle with specific clarifications along with exceptions and limitations on the exceptions. At some point, such an articulation becomes better classified as a rule. Indeed, the more such specificity is provided, the more rule-like is the law. For unanticipated cases, the original principle - when conjoined with the articulated exceptions - remains a principle that can be invoked to determine what conduct is required - disclosure or confidentiality, for example. It is rarely possible, however, to prevent the principle from morphing into rules. New fact patterns appear and participants make contextual judgments about on which side of the principle an event resides. Such decisions are made as a matter of practice - becoming norms - and in enforcement. The law thus evolves

[4] *See* William W. Bratton, Jr., *Private Standards, Public Governance: A New Look at the Financial Accounting Standards Board*, 46 BC L. REV. (forthcoming 2006).

from an abstract statement of principle into synthesized expressions bearing rule-like attributes.

An alternative way emerges to evaluate whether a positive law is better classified as a rule or principle. It concerns the attributes of the statement - its relative generality, the extent of specified clarification and detail, and the scope of exceptions and limitations on the exceptions. It thus is possible to classify an array of laws as principles, such as disclose promptly, invest client funds prudently in accordance with client preference, exhibit loyalty when in a special relationship or demonstrate "commercial honour" and "becoming conduct". But these abstractions require some specificity in particular applications. So rules state prospectus delivery times, define prudence to mean investing for risk-averse clients only in AAA bonds not junk bonds, explain that special relationships include an employer-employee, and that "commercial honour" or "becoming conduct" prohibits designated acts of turpitude such as trading for clients without prior written authorization.

Any approach to classifying laws as rules or principles thus leaves room for refinement. Some may be readily recognizable as a broad principle (prudence) and others as a detailed rule (filings must be made within 10 days). The vast majority of securities laws and regulations in the U.S. and Canada reside between these endpoints, constituting a continuum of rules and principles. Within this vast range, moreover, more textured descriptions other than rules or principles appear possible, such as factor tests.[5] A legal principle that prohibits market manipulation, for example, may be tested according to factors such as the timing, frequency and structure of given trades. Likewise, securities laws and regulations may involve the use of presumptions that may be rebutted, having a principles- or rules-like quality.

In a system of legal statements - such as the body of securities law and regulations in a given jurisdiction - it is essentially impossible to avoid having a combination of rules and principles. Indeed it is desirable to have a mix of rules and principles because their relative efficacy varies with contexts. How should the legal obligations of securities brokers be articulated as to whether to buy or recommend a particular security? One possibility is a rule that prohibits buying or recommending anything other than AAA-rated bonds. Another is a principle of diligence directing the broker to evaluate the investment's suitability in relation to the customer's identified risk tolerance and investment objectives.

The rule appeals for its relative certainty and predictability; the principle appeals for its relative capacity to exploit advantageous circumstances and possibly avoid undesirable ones. On the downside, rules can be mere blueprints for evading their underlying purposes. Bright-lines and exceptions to exceptions

[5] *See* Sunstein, *Problems with Rules*, *supra* note 2.

facilitate strategic evasion, meaning artful dodging of a rule's spirit by literal compliance with its technical letter. The result is gestures of adherence, not acts of fulfillment. Principles pose the opposite problem of uncertainty and ex post surprise, which can diminish both market efficiency and public perceptions of fairness.

The upshot remains the same: there is need for balance between principles and rules. Both likely are necessary for a rational system of securities regulation. While the ideal solution may be contestable in a given case, the desirability of a rule or principle may be clearer in some cases than in others. The clarity depends on the possibility of defining the importance of relative values or objectives. Most generally, this involves determining which is more important: predictability and certainty, or fairness and context. Constraining discretion to promote predictability and certainty means rules; emphasizing fairness and contextual sensitivity means principles. A rational system of securities regulation will present circumstances where certainty is more important than context and vice versa.

It is tempting to examine a system and draw conclusions as to whether it is more nearly rules-based or principles-based when compared to other systems or hypothetical possibilities. Indeed, lawmakers may consciously attempt to bias the system in favour of one end of the spectrum or the other. Commentators thus routinely describe the U.S. securities regulation system as rules-based[6] while lawmakers in British Columbia have articulated what they call a principles-based system as an alternative to what they see as a Canadian trend to follow the U.S. rules-based model.[7]

Some are tempted to delineate systems that are at the absolute extremes - either principles-only or rules-only. Such delineations seem difficult to sustain, even as a theoretical matter. Rules must be connected to a principle, either in articulation of a rational and legitimate set of rules or as a result of a study of the rules that would enable extracting general principles.[8] Likewise, principles result in applications of given instances and those instances of principle application generate laws inherently bearing a rule-like quality. The principle of commercial honour applied to a broker who traded excessively in his client's accounts produces a result bearing a rule-like quality (such as that account turnover exceeding 4.0 is a violation). Even the vaguest principles - such as "the public interest" - can assume rule-like attributes as a result of repeated invocation, although this is an extremely open-textured and contingent concept.

---

[6] *E.g.*, Ruth O. Kuras, *Harmonization of Securities Regulation Standards between Canada and the United States*, 81 U. DETROIT MERCY L. REV. 465 (2004).
[7] Proposed British Columbia Securities Act, SBC 2004 c 43 (not enacted as law).
[8] *See* Michel Rosenfeld, *Contract and Justice: The Relationship between Classical Contract Law and Social Contract Theory*, 70 IOWA L. REV. 769 (1985).

The inevitable blending of rules and principles leads away from consciously attempting to fashion a rules- or principles-based system and towards an objectives-based orientation in articulating law. The SEC demonstrated this aspiration in its study of the financial disclosure component of securities regulation, focusing on the parallel rules-principles debate in accounting that erupted amid the scandals leading to the U.S. Sarbanes-Oxley Act of 2002 ("SOX").[9] Some attributed those and other debacles to an accounting system comprised more of rules than of principles.[10] Rule-bound accounting could enable technical compliance while failing to reflect fairly underlying economic reality. Section 108 of SOX required the SEC to conduct a "study on the adoption by the United States financial reporting system of a principles-based accounting system" [hereinafter called the "SOX 108 Study"].[11]

The SOX 108 Study identified the typical shortcomings of rules-based standards noted above. The SEC observed that standards reside along a continuum according to their "degrees of specificity", "ranging from the abstract, at one end, to the very specific at the other". The SEC also denominated a class of principles-only standards, defined as "high-level standards with little if any operational guidance". A good example might be the broad concept of the "public interest". Absent sufficient guidance, these require exercising judgment without a reliable framework for doing so - and risk ad hoc enforcement arbitrariness. The SEC concocted and endorsed the concept of an "objectives-oriented" approach to assert that resulting standards would "land solidly between the two ends of this spectrum".[12] The SEC opined that such an objectives-orientation would best be achieved using "principles-based standards".

Thus the SEC explains that, in contrast to rules-based and principles-only systems, a principles-based system uses concise statements of principle with the related objective incorporated as an integral part. It would contain no or few exceptions or internal inconsistencies, a modicum of guidance, no bright-line tests and be derived from an underlying coherent conceptual framework.[13] A standard bearing these attributes, the SEC said, is objectives-oriented because: application entails fulfilling the objective and so minimizes strategic evasion; articulation entails an overall coherence across the regulatory terrain; it

---

[9] *See* Lawrence A. Cunningham, *The Sarbanes-Oxley Yawn: Heavy Rhetoric, Light Reform (And It Might Just Work)*, 35 CONN. L. REV. 915 (2003).
[10] *See* Frederick Gill, *Principles-Based Accounting Principles*, 28 N. C. J. INT'L L. & COMM. REG. 967 (2003); Matthew A. Melone, *United States Accounting Standards: Rules or Principles? The Devil Is Not in the Details,* 58 U. MIAMI L. REV. 1161 (2004).
[11] Securities and Exchange Commission, Study Pursuant to Section 108(d) of the Sarbanes-Oxley Act of 2002 on the Adoption by the United States Financial Reporting System of a Principles-Based Accounting System (2003) [*hereinafter*, the "SOX 108 Study"].
[12] *Id.*
[13] *Id.*

eschews exceptions that otherwise lead to inconsistencies within the standard and require more detailed guidance; and it eschews bright-line tests that otherwise lead to different regulatory consequences for only slightly different fact patterns.[14]

In accounting, the SEC aspires to promote "objectives-oriented" or "principles-based standards" that compel a focus on substance by directives that are neither too abstract nor too dense but that expressly incorporate the substantive objectives to be achieved. Such standards impose greater responsibility on regulated actors than either rules-based standards or principles-only standards, according to the SEC. After all, no standard can displace the exercise of judgment in a given context because no standard can ever sufficiently identify the myriad situations to which it may apply. Yet excessively detailed standards rob value from the context-specific knowledge that those exercising judgment posses in facing a particular decision.[15]

Despite the superficial appeal and apparent force of the SEC position, some perspective is in order. As a background matter, there existed an apparent dichotomy between complying with generally accepted accounting principles (GAAP) on the one hand, and providing a fair financial presentation on the other.[16] With some fanfare, the SEC addressed this possible dichotomy after Enron Corp. imploded by saying that if complying with GAAP does not produce a fair presentation, then compliance with GAAP is subordinated to promoting a fair presentation.[17] In such cases, GAAP must be overridden. This stance threatened the existing financial reporting system, however, which for decades had assumed that complying with GAAP would yield a fair presentation.[18]

---

[14] *Id.*
[15] *Id.*
[16] *See United States v. Simon*, 425 F2d 796 (2nd Cir. 1969) (Friendly, J.), *cert. denied*, 397 U.S. 1006 (1970); *Kripps v. Touche Ross & Co*. [1997] BCJ no. 968 (CA).
[17] SEC SOX 108 STUDY, *supra* note 11; *see also* SECURITIES AND EXCHANGE COMMISSION, CERTIFICATION OF DISCLOSURE IN COMPANIES' QUARTERLY AND ANNUAL REPORTS, RELEASE NO. 33-8124 (Aug. 28, 2002), which states as follows:

> The [auditor's] certification statement regarding fair presentation of financial statements and other financial information is not limited to a representation that the financial statements and other financial information have been presented in accordance with "generally accepted accounting principles" and is not otherwise limited by reference to generally accepted accounting principles.

[18] This belief is embedded in the standard form of an independent auditor's unqualified opinion, which usually reads as follows: "In our opinion, the financial statements referred to above *present fairly*, in all material respects, the financial position of X Company as of (at) December 31, [20xx], and the results of its operations and its cash flows for the year then ended, *in conformity with generally accepted accounting principles*." *See* AICPA, Statement on Auditing Standards No. 69 (emphasis added). AICPA explains how these concepts of "present fairly" and GAAP relate to each other: "The independent auditor's judgment concerning the 'fairness' of the overall presentation of financial statements should be applied within the framework of generally accepted accounting principles." *Id*. This professional stance implies that there are not two separate requirements—of presenting fairly and in conformity with GAAP—but that the two are intertwined. On the other hand, professional standards authorized departures from

If too rule-bound, compliance with the GAAP rule-book would impair the possibility of meeting the fairly-presents principle. A crisis loomed: if the widely held assumption of GAAP as rules-excessive were true, then GAAP had to be reinvented - *post haste*. After all, complying with that kind of GAAP would frequently mean absence of a fair presentation. If the principle of fair presentation is privileged, then a rules-based GAAP makes itself functionally irrelevant.

The weight of rhetoric notwithstanding, the assumption of GAAP's rule-bound nature was false. The SEC found that existing GAAP is a mixture of rules and principles. It declared the mixture substantially effective, and renamed it an objectives-based system. The SEC's SOX 108 Study indicated that, under such a system, there should be limited need ever to indulge a GAAP override. Complying with objectives-based GAAP yields financial statements that are "fairly presented". This conclusion thus resolved what otherwise loomed as a crisis: that a rule-bound GAAP would have to be scrapped if it could not satisfy the fair presentation principle.

The SEC's elaborate study of the rules-principles dichotomy shows the dichotomy's falsity. The SEC ultimately expresses the view that U.S. GAAP is a mix of principles and rules, and designates neither as inherently superior. Instead, it embraces what it believes to be a hybrid, which it calls an "objectives-based" system. It boils down to a different name for the prevailing mix of rules and principles, all intended to promote financial statements that "fairly present" financial condition and performance.

This resolution of the false dichotomy is correct, and suggests that the struggle that went into it was more cathartic than substantive. The issue is not whether one may prefer a rules-based system to a principles-based system. Substantively, there should be no such thing. The issue is whether, for a given context, a rule or principle is superior. That depends, in turn, on whether certainty or context is more important - and the answer varies across subject matter types within a securities regulation framework. The question is indeed one of objectives.

While the SEC was writing its SOX 108 Study, the British Columbia Securities Commission drafted a system of securities regulation accompanied by explanations resembling the SEC's exhortations for accounting. Likewise calling it alternately a principles-based and objectives-based system, the proposal

---

GAAP when doing so was necessary to prevent financial statements from being "misleading." AICPA, Statement on Auditing Standards No. 58, ¶14. Such opinions have been extremely rare. *See* DAN M. GUY *ET AL.*, WILEY PRACTITIONER'S GUIDE TO GAAS (2004), at 361 ("Only a handful of such reports have ever been issued."); *see also id.* at 365 (excerpting an example from 1976). The SEC's 2002 statement, quoted in the previous footnote, unsettles such understandings that the concept of "present fairly" was integral to conforming with GAAP.

attempted to state in the most general possible terms the requirements of a rational system of securities regulation. It boasted that the "new approach leaves behind the over-use of detailed and prescriptive rules in favour of an outcomes-based approach founded on time-tested principles of investor protection: disclosure to investors and the regulation of dealers and brokers".[19] It sought to jettison excess complexity and overcome obsolescence, focusing on outcomes, not processes.

A general example suggested how a continuous disclosure system rendered prospectus delivery requirements "essentially redundant".[20] A more specific example considered the problem of conflicts of interest. Existing legislation used process-driven requirements that prohibited specific transactions, prescribed procedures for some and compelled disclosure in yet others. The result was over-inclusion or under-inclusion. The new results-based approach requires conflict resolution in the client's favour and disclosing to the client anything that would lead a reasonable investor to question the advisor's objectivity. As to enforcement, the proposal's general design is to promote cultures of compliance rather than fixation on specific rules. Despite the principles-based rhetoric, however, the proposed legislation is accompanied by a Code of Conduct containing 28 rules regulating dealers and advisors in various specific ways, including compelling disclosure about their compensation.

Other Canadian provinces - each of which maintains separate securities laws - resisted the initiative amid concurrent struggles to develop a harmonized securities regulatory system nationwide, including through the concept of a passport system.[21] While British Columbia thus widely publicized this "modern, innovative" proposal in 2004, it has not implemented it. Instead, with continuing progress towards achieving a nationwide passport system, the Province announced in February 2006 that it would continue to suspend implementation of its proposal until at least late 2007 or 2008.[22]

Proponents of principles-based over rules-based law or standards face uphill battles - whether British Columbia in securities regulation or the SEC in accounting. Across a wide range of law-making and standard-setting contexts, the decided trend has been towards rules and away from principles. Apart from how rules simply germinate from principles and regenerate new rule-like attributes, systemic forces push in that direction. One observes such forces not only in accounting and securities regulation, but also in

[19] British Columbia Securities Commission, *Questions and Answers on New British Columbia Securities Act*, SBC 2004 c 43, at 1.
[20] *Id*.
[21] *See* Memorandum of Understanding Regarding Securities Regulation (Sept. 30, 2004) (signed by ministers from most Canadian provinces and territories to establish a Canadian passport system).
[22] *See* British Columbia Securities Commission News Release, Securities Laws to be Harmonized Across Canada (Feb. 10, 2006).

contracting exercises among private parties.[23] While such forces may be more pronounced in jurisdictions routinely classified as exhibiting rule-based approaches compared to those seen as embracing principles-based approaches, the trend is not isolated.[24]

Numerous forces explain - and sustain - the trend. First, participants seek clarity and predictability in financial markets where tools increasingly facilitate the apprehension of precise measurement of various kinds of risk (from interest and currency rate fluctuations and commodity price changes to political and weather hazards).[25] This stokes an appetite to measure regulatory and enforcement risk as well. That means rules.

Second, the so-called new governance within administrative law features regulators and compliers increasingly participating together in promulgation exercises.[26] The administrative state has blossomed into one of open government, collaborative governance, and extensive private standard setting.[27] In such negotiated exercises, it is not surprising that resulting articulations would be more specific than general, with various constituents staking claim to particular needs for qualifications, exceptions and other features of rules than of principles. Good evidence and examples of the resulting products are the NASD Manual and IDA Rule Book.[28] Others appear throughout contemporary securities regulation production in the forms of safe harbours and other stated exemptions.[29]

Third, political pressure to act in response to high-visibility debacles provokes regulators to action that often assumes the forms of rules. Indeed, while the SEC's Section 108 Study and the British Columbia reform were articulated in the wake of large-scale securities frauds in the U.S. and Canada, related regulatory actions in both countries resulted in the articulation of more securities laws recognizable as

---

[23] *See* Claire A. Hill, *Why Contracts are Written in "Legalese*", 77 CHI.-KENT. L. REV. 59 (2001).
[24] *See* Claire A. Hill & Christopher King, *How Do German Contracts Do as Much with Fewer Words?*, 79 CHI.-KENT L. REV. 889 (2004); Craig Ehrlich & Dae-Seob Kang, *U.S. Style Corporate Governance in Korea's Largest Companies*, 18 UCLA PAC. BASIN L.J. 1 (2000).
[25] *See*, *e.g.*, JEAN TIROLE, THE THEORY OF CORPORATE FINANCE (2006).
[26] See e.g., Jody Freeman, The Private Role in Public Governance, 75 NYU L. REV. 543 (2000); Jody Freeman, Collaborative Governance in the Administrative State, 45 UCLA L. REV. 1 (1997); see also Paul R. Verkuil, Public Law Limitations on Privatization of Government Functions, 84 N.C. L. Rev. 397 (2006).
[27] *See* JAY A. SIGLER & JOSEPH E. MURPHY. INTERACTIVE CORPORATE COMPLIANCE (1988); IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION: TRANSCENDING THE DEREGULATION DEBATE (1992); Lawrence A. Cunningham, *Private Standards in Public Law: Copyright, Lawmaking and the Case of Accounting*, 104 MICH. L. REV. 291 (2005).
[28] *See infra* Section 4.B.
[29] *E.g.*, Securities Act Rule 175 and Exchange Act Rule 3b-6; Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 77z-2 (Section 27A of the 1933 Act) and 15 U.S.C. § 78u-5(c) (Section 21E of the 1934 Act).

rules - SOX in the U.S.[30] and a series of initiatives led by the Ontario Securities Commission in Canada, colloquially known as SoxCAN.[31] This even occurred in the context of U.S. accounting. Despite the SEC's exhortations to move towards a principles-based approach to accounting, it concurrently adopted detailed regulations governing off-balance sheet financing and the use of non-GAAP measures.[32]

Fourth, increasing specialization drives professionals across many disciplines towards greater statements of details. As securities markets fragment, differential treatment becomes necessary for different kinds of securities or issuers. Old-fashioned industrial issuers are very different from mutual funds; both of these differ from hedge funds. Common stock and straight-debt are very different instruments than preferred stock, call or put options, asset-backed debt, strips, and derivatives. Accompanying specialization and fragmentation are economic incentives to claim expertise by proprietors and other professionals and to claim turf by standard setters or lawmakers. Illustrative are debates in the derivatives markets between the SEC and the Commodities Futures Trading Commission (CFTC), and both of these with the trade group, International Swap Dealers Association (ISDA).[33] The value of rents that interested groups can claim is greater when specialized rules govern rather than broad general principles.

Fifth, demand for specific rules arises from professional advisors participating in related transactions. Sometimes they need support from specific rulebooks to cite when encouraging clients to take a more conservative or prudential approach to a transaction.[34] Across all settings where risks and pressures of rent-seeking are high - whether managers seeking no-action letters from regulators, legal opinions from lawyers or clean audit letters from auditors - rules that limit or eliminate regulatory or professional discretion help to deflect such managerial appeals.[35]

---

[30] Public Company Accounting Reform and Investor Protection Act of 2002, 107 Pub. L. No. 204, 116 Stat. 745 (popularly known as Sarbanes-Oxley or SOX), codified in scattered sections of U.S.C.

[31] *See* Robert Wright, *Enron: The Ambitious and the Greedy*, 16 WINDSOR REV. L. & SOC. ISSUES 71 (2003); Mary Condon, *Enforcement and Litigation in Ontario Securities Regulation*: *Time for a Rethink?*, QUEEN'S L. J. (forthcoming 2006) (draft at 8, n. 25).

[32] SEC Release, Off-Balance Sheet Arrangements (Jan. 28, 2003); SEC Regulation G: Conditions for Use of Non-GAAP Financial Measures. These are especially interesting exhibits because the SEC takes pains to describe the documents as constituting "principles-based" approaches to these subjects.

[33] *See* Frank Partnoy, *The Shifting Contours of Global Derivatives Regulation*, 22 U. PA. J. INT'L ECON. L. 421 (2001).

[34] This is especially true of auditors advising management concerning the accounting treatment of novel transactions, where rules fortify the auditor's spine. *See* William W. Bratton, *Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023 (2003).

[35] *See* Stewart E. Sterk, *Information Production and Rent-Seeking in Law School Administration: Rules and Discretion*, 83 BU L. REV. 1141 (2003).

The upshot of these forces is that even when it is determined that a principle is superior for a given setting, offering a principles-based framework over a rule is difficult. It also is difficult - and may be undesirable - to repeal rules once in effect in favour of principles.[36] Both rules and principles may fall into desuetude but rules remain on the books in ways that principles do not. This was one of the motivations for the British Columbia proposal. The reception to that proposal also shows the difficulty of conquering rule inertia. True, Canadian resistance to the British Columbia proposal arose from how it bucked the goal of national uniformity across Canada[37] and seemed to be in tension with international harmonization, especially with U.S. laws, seen as more rules-bound.[38] But that begs the question: why do the U.S. and other Canadian provinces exhibit tendencies towards rules-based securities regulation? The foregoing systemic forces favouring rules contribute powerfully. Rule retention may be desirable, moreover, to the extent that their previous promulgation and continued existence create and codify desirable norms.

Proponents of principles-based securities regulation need not lament, however. Amid powerful trends favouring rule bias are a set of powerful sub-trends signalling increasing effort toward what may be called pre-emptive enforcement. This is increased emphasis on promoting substantive compliance through mandatory internal controls rather than threatened enforcement of substantive violations. For example, SOX requires a comprehensive internal control framework, including auditing and reporting on internal control effectiveness.[39] This kind of early warning system also appears in Canada's risk capital framework applicable to securities firms.[40] In part, these devices emphasize a primary goal of promoting internal rather than external enforcement of the substantive provisions of securities regulation, from disclosure to solvency.

The sub-trend towards such early warning systems shows a focus one step forward, on policy making and the internal rather than policy enforcement and the external. This is particularly appealing given how,

---

[36] *See* JAMES D. COX, ROBERT HILLMAN & DONALD LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS, (2d ed. 1997) at 315 (discussing the underwriter stabilization exception to market manipulation rules, Regulation M's 1997 adoption was an effort to overcome the previous framework, in Rule 10b-6, which critics saw as overbroad and containing excruciating technical details, including 13 different exemptions; despite this conscious effort to shift from a rules-based approach towards a principles-based approach, the current law remains heavily rule-based).

[37] *See* MARY G. CONDON, ANITA I. ANAND & JANIS P. SARRA, SECURITIES LAW IN CANADA: CASES AND COMMENTARY (2005), at 352-53 & 388.

[38] *See* Sukanya Pillay, *Forcing Canada's Hand? The Effect of the Sarbanes-Oxley Act on Canadian Corporate Governance Reform*, 30 MAN. L.J. 285 (2004).

[39] SOX, §403; *see* Lawrence A. Cunningham, *Facilitating Auditing's New Early Warning System: Control Disclosure, Auditor Liability and Safe Harbors*, 55 HASTINGS L. J. 1451 (2004).

[40] *See* Investment Dealers Association, Reg. 1300.1(o), 1300.2 & Policy No. 2; *TD Waterhouse Canada Inc*. (IDA Enforcement Action, 2004/12/16); *RBC Dominion Securities Inc*. (IDA Enforcement Action, 2004/12/16); *BMO Nesbitt Burns Inc*. (IDA Enforcement Action, 2004/12/16).

when deciding whether to craft a law as rule or principle, it is not always clear whether certainty or context is more important. It is tempting to establish a system of laws that need not make such trade-offs. That appears to be one temptation lying beneath the SOX 108 Study and the British Columbia proposal—establishing a systemic framework biased in favour of principles. Announcing such a systemic bias may reflect difficulties inherent in deciding when a principle or rule is superior, that is, when certainty or context is to be privileged.

It will remain difficult to navigate the trade-off between certainty and context, and a principles-based system is essentially a conceptual fantasy given the complex relation of principles to rules. But an alternative may offer appealing practical guidance. The somewhat paradoxical proposition suggests that principles are best-suited for both long-known boundaries or frameworks (norms) and utter novelties. Examples of such norms are proscriptions against forgery. These do not require detailed rules to provide guidance or to promote recognition. Novelties cannot be anticipated, by definition. For example, when first used, were derivative financial instruments a security or commodity, so that either SEC or CFTC regulations apply? It could not be known without further experience with the products.

Rules are appealing for all other cases: lesser-known matters for which norms have not yet been recognized but that are not so novel that they elude anticipation. For example, once derivatives exist and experience with them generates knowledge useful in making category distinctions - but before they are so widespread as to produce a norm-based association - rules are both legitimate and necessary to channel conduct. For these circumstances, the ex ante instructions that rules provide are necessary and learning to follow the instructions is worthwhile.[41] Here rules play an important norm creation and immediacy function.[42] Certainty is thus more important than context. Once such norms congeal, the need for newly-articulated rules diminishes and statements of principle suffice - context can be privileged over certainty, although rule retention may remain desirable as an instantiation of norms.

This pragmatic framework ties in to two main points made in the foregoing discussion. First, a focus on internal control is a focus on norm instantiation. It is a framework designed to promote a culture of

[41] *See* Kaplow, *supra* note 2, at 570-77 (rules more nearly optimal than principles to address homogenous recurrent fact patterns where actors need ex ante instructions and have incentives to invest in compliance).
[42] *See* Dorothy Thornton, Neil A. Gunningham & Robert A. Kagan, *General Deterrence and Corporate Environmental Behaviour*, 27 L. & POLICY 262 (2005); Neil A. Gunningham & Robert A. Kagan, *Regulation and Business Behaviour*, 27 L. & POLICY 213 (2005); John C. Coffee, Jr., *Does "Unlawful" Mean "Criminal"?: Reflections on the Disappearing Tort/Crime Distinction in American Law*, 71 B.U. L. REV. 193 (1991); Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71; *compare* John C. Coffee, Jr., *Do Norms Matter? A Cross-Country Examination of the Benefits of Private Control*, 141 U. PA. L. REV. 2151 (2001) (suggesting hypothesis that norms matter most when law is weakest).

compliance. That means a need not only to comply with hoary old principles, but the need to identify proper principles even absent detailed rules, including especially how to handle novel situations. This leads into the second point, of how lawmakers amid public debacles posing novel questions respond not only by principles-based enforcement of violators, but also by promulgating new detailed rules proscribing the conduct at issue. Again, good examples are how Enron used off-balance sheet structures and non-GAAP measures to facilitate its deceptions. In addition to criminal and civil enforcement actions crying foul, the SEC adopted detailed rules respecting off-balance sheet financing and non-GAAP measures.

To summarize, rules and principles are imperfect categories to describe laws. While some laws may fit neatly into such descriptions, most blend aspects of each and rational systems of law invariably partake of hybrids running across the continuum from end-to-end. Ambitions to emphasize one or the other abstractly may miss out on the importance of assessing particular value importance of certainty versus context or of norms versus novelty. As important, when regulators seek to elevate one or the other, attention must be paid to the consequences of doing so on enforcement activity and effectiveness, considered next. This is particularly so when bias tempts regulators to enforce "principles-only" articulations.

ii. Enforcement

Many different actors participate in enforcing securities laws. Most immediately, enforcement occurs internally within regulated firms (whether issuers or securities professionals). This involves a system of internal control designed to promote compliance and penalize and correct non-compliance. It hinges, in turn, on prevailing norms and peer pressure as well as market forces. Second-order enforcement is imposed by public officials (such as the SEC and CSA member commissions) and, for securities professionals, professional enforcers (such as NASD and IDA and "other self-regulatory organizations," or SROs). Private actors reinforce these internal and external regulatory mechanisms.

In each case, whether rules or principles are either easier to enforce or to violate are important - and hotly debated - questions. For example, some contend that self-enforcement through norms usually is inadequate.[43] Others present evidence suggesting that private enforcement of principles-based laws best

[43] *See* Renee M. Jones, *Social Norms and Corporate Conduct*, 91 IOWA L. REV. (forthcoming 2006); *see also* Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253 (1999).

effectuates securities regulation's goals of deep and efficient capital markets.[44] While privately-enforced principles may be appealing, as a practical matter, public and professional enforcement are here to stay, and rules as well as principles are here to stay.[45] Indeed, rules continue to increase their dominance in securities regulation - despite occasional contrary regulatory aspirations - making an important and enduring question how rules or principles affect public and professional enforcement activity and effectiveness.

Regulators possessing enforcement authority, including overseers of Canadian and U.S. securities markets, combine rule-making and enforcement exercises as part of an overall regulatory program. At one extreme, a regulator may emphasize its rulemaking function and provide detailed guidance following a prescribed public rulemaking procedure in which constituents have input. At the other, it may eschew such ex ante rulemaking and emphasize instead the development of laws through enforcement based on departures from principles. Most agencies show pursuit of a combination of these.

In certain contexts, agencies exhibit a bias towards regulation by enforcement of principles rather than by clear ex ante articulation of regulations. Thus, the SEC, for example:

> "has, at times, resorted to ad hoc enforcement of the federal securities laws in particular contexts, in the absence of meaningful advance guidance (or warning) . . . in large measure because of the agency's institutional fear that any specific regulations it might promulgate could prove under-inclusive or susceptible of easy evasion".[46]

In addition to such "fear-based" bias, it can be easier for agencies to regulate by enforcing principles rather than pursue elaborate rulemaking processes. Rulemaking requires the agency "to develop and

---

[44] *See* Rafael La Porta, *et al*., *What Works in Securities Law?*, NBRE WORKING PAPER NO. 9882 (2003).

[45] Accordingly, this study is limited to public and professional enforcement, not private enforcement. The influence of rules versus principles on private enforcement activity and effectiveness likely differ compared to that of public and professional enforcement. Private enforcement differs radically. It is run by the plaintiffs' bar with modest judicial supervision and laced with weaknesses and subject to a wide variety of criticisms that are distinct from those applicable to public and professional enforcement. *See* John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, COLUMBIA L. & ECON. WORKING PAPER NO. 293 (2006); Elliott J. Weiss & Lawrence J. White, *File Early Then Free-Ride: How Delaware Law (Mis)Shapes Shareholder Class Actions*, 57 VAND. L. REV. 1797 (2004). So while there are complex interplays between private and public/professional enforcement, including in relation to rules and principles, these are beyond the scope of this study. On some of these complexities, see Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation By Enforcement: A Look Ahead At the Next Decade*, 7 YALE J. REG. 149, 183 (1990) (private actors may be willing to pursue theories and establish resulting laws that can disadvantage public enforcers in later proceedings, including through selection of cases as between rules and principles). Nevertheless, some additional reflections on the special complexities associated with private enforcement are provided in Section 4.C.

[46] *See* Pitt & Shapiro, *supra* note 45, at 156.

maintain comprehensive regulatory responses to difficult and technical industry and professional issues."[47] Principles-based enforcement is enabled and eased by numerous attributes of such agencies that give them considerable latitude in agenda setting.[48]

The use of broad principles-based enforcement appears to be most common - and legitimate - when confronting novel or changing characteristics of the securities industry.[49] They include confronting peculiarities such as technological innovation and political change requiring enforcement concerning securities offerings at the dawns of the Internet[50] and globalization.[51] They also include episodic bouts of securities law violations associated with systemic plagues, such as insider trading and junk bonds in the 1980s to early 1990s and research analysts and mutual fund market timing problems in the late 1990s to early 2000s.[52]

Despite such occasional ad hoc enforcement activity, the vast majority of SEC enforcement actions take an approach more nearly rooted in extant laws and regulations that range across the spectrum of both securities law itself and the rules-principles continuum. This range of actions, numbering in the thousands in recent years and at least 500 annually for more than a decade, shows some year-to-year variation in specific content, but the enforcement program's mix of case types has been remarkably stable over the past decade.[53]

---

[47] *Id*. at 156.
[48] *Id*. at 156-57 (detailing these attributes of agency discretion).
[49] *See* William R. McLucas, J. Lynn Taylor, & Susan A. Mathews, *A Practitioner's Guide to the SEC's Investigative and Enforcement Process*, 70 TEMP. L. REV. 53 at n.74 (1997) ("Since 1991, the number of registered investment companies has increased by approximately 34%, and the amount of assets held by registered investment companies has increased by approximately 119%") (citing SEC Annual Report (1995) at 133) (and stating that "As a result, enforcement actions involving investment companies have become a more significant part of the Commission's enforcement program.").
[50] *E.g.*, *SEC v. Spencer*, SEC Lit. Rel. No. 14,856, 1996 WL 145918 (S.E.C.) (Mar. 29, 1996) (Internet solicitation of investors promising 50% returns); *SEC v. Frye*, SEC Lit. Rel. No. 14,720, 1995 WL 686628 (S.E.C.) (Nov. 15, 1995) (Internet solicitation of investor promising risk-free profits); *SEC v. Odulo*, SEC Lit. Rel. Nos. 14,591, 1995 WL 493347 (S.E.C.) (Aug. 7, 1995), and 14,616, 1995 WL 505138 (Aug. 24, 1995) (Internet solicitation promising 20% return).
[51] *See In re Candies, Inc*., Sec. Act Rel. No. 7,263, 1996 WL 75741 (S.E.C.), at *1 (Feb. 21, 1996) (cease-and-desist proceeding against law firm assisting in scheme to violate Securities Act registration requirements by distributing abroad unregistered stock where the stock was promptly resold back into United States); *SEC v. Scorpion Technologies, Inc*., SEC Lit. Rel. No. 14,814, 1996 WL 74046 (S.E.C.), at *1 (Feb. 9, 1996) (injunction to stop illegal Regulation S offering of stock in 20 countries).
[52] *See infra* text accompanying notes 131-135.
[53] *See* McLucas, Taylor, & Mathews, *supra* note 49, at n.3 ("In recent years, for example, the Commission has brought enforcement actions involving fraudulent offerings of securities on the Internet, wireless cable schemes, and violations of the securities laws in municipal bond offerings."); *compare id.* at 62-63 *with* SEC Annual Report (2005) and SEC Annual Report (2004) (each organizing case distributions in substantially similar classifications of insider trading, market manipulation, financial disclosure, securities firms and securities offerings).

For the SEC, the range and type of cases chosen for enforcement in given environments flows from its broad investigative authority.[54] Many different sources of information trigger SEC investigations, none of which seems to be systematically connected to whether an underlying violation assertion hinges upon application of a rules-based law or a principles-based law. Thus investigations may be triggered by SEC review of filings, SEC inspections, market surveillance (by the SEC or SROs) and customer or public complaints.[55] Specific investigative actions are begun at the staff level and require the Commission's approval.[56] Investigative techniques vary with the type of action posed, usually being more complex when pursuing principles-like violations and more straightforward when pursuing rules-like violations.

Discussions of Canadian regulatory enforcement dispositions tend to resemble this broader-gauged SEC approach to case selection, except with a slight bias towards enforcing rules. Across the provinces, case generation and selection appears to parallel the SEC's approach, with complaints coming from many sources, including members of the public and referrals from other governmental agencies or other securities commissions. These are investigated, closed, referred, or sometimes litigated. In all cases, limited resources require structuring discretion.[57] The standard mechanism for doing so is denominated as risk-based regulation. It entails evaluation of a matter's attributes signalling relative importance in the overall securities law system, including relative size, previous violations, internal compliance systems in place, capital base, and experience of management.[58]

Apart from this risk-based mechanism, and sorting cases into subject matter categories, Canadian enforcement staff offer limited public guidance on case selection. For example, the Ontario Securities Commission (OSC) does not disclose the priorities among its case categories. Commentators welcome the statement of case selection criteria, and regard them as sensible, but lament how the guidance offers no clue concerning how to measure "investigative value" or how the OSC determines what is "a high priority issue."[59] The OSC does not clarify how it makes such decisions and with possible good reason: ex ante, it cannot know what problems are likely to arise. Moreover, given limited resources, bias of enforcement in favour of simpler cases - based on rules violations - may exist but the commission must simultaneously

[54] *See SEC v. Arthur Young & Co*., 584 F.2d 1018, 1033-34 (D.C. Cir. 1978).
[55] *See* McLucas, Taylor, & Mathews, *supra* note 49, at 62.
[56] *See* Securities Act 20(a), 15 U.S.C. 77t(a) (1994); Exchange Act 21(a)(1), *id.* 78u(a)(1); Advisers Act 209(a), *id.* 80b-9(a); Investment Company Act 42(a), *id.* 80a-41(a); Public Utility Holding Company Act 18(a), id. 79r; and Trust Indenture Act 321(a), id. 77s; McLucas, Taylor, & Mathews, *supra* note 49, at n.23 (citing *SEC v. Arthur Young & Co*., 584 F.2d 1018, 1028 (D.C. Cir. 1978)).
[57] *See* Puri, *Enforcement Effectiveness in the Canadian Capital Markets*, *supra* note 1, at 15-18.
[58] *Id*. at 16 ("Theme of resources appears to be central to the risk-based approach . . . .").
[59] See Condon, Enforcement and Litigation in Ontario Securities Regulation, supra note 31.

conserve those resources when needed to pursue more complex matters that involve violations of principles.

These accounts of case selection invite consideration of a classification of enforcement priorities as being principles-privileged or rules-privileged. The summary suggests some enforcement preference for cases rooted in violations of rules rather than principles - with a ready safety valve of principles-based enforcement available to combat violations that generate pubic attention and rebuke or that pose novel problems. Within such a system, tension between rules on the books and abstract principles can arise.

To resolve the tension, a system of law (including securities regulation) may contain explicit standards for privileging one or the other. Equity is the magisterial example of how principles may be used to override rules. In financial accounting, the GAAP override illustrates the same function by privileging the principle of a fair presentation of financial statements when applying specific GAAP would impair that result. Such a hierarchy can be described as principles-privileged or rules-subordinated.

Both the SOX 108 Study and the British Columbia principles initiative take this possibility seriously, although both seem to do so with a view towards strengthening the regulator's safety valve by enabling it to enforce the principle rather than allowing principles to override rules. But for enforcement, a determined bias towards principles instead of rules presents risk of backfire when incongruent with received notions of fairness. The concern can be illustrated by comparing administrative law in the U.S. and Canada.

In the U.S., when administrative agencies promulgate rules, and parties adhere to those rules, the agency is not permitted to challenge that compliance by citing an alternative broader principle.[60] This suggests a rules-privileged enforcement environment rather than a principles-privileged one. To the extent that the SEC would prefer to formulate principles-based law rather than rules-based law, this implies a neutralization of that constraint. In contrast, in most Canadian securities law enforcement, it is possible for a party to violate law even when no violation of any specific rule is asserted.[61] This is known as

[60] *See Arizona Grocery Co. v. Atchison, T&SF Ry. Co.*, 284 U.S. 370 (1932). This alone does not prevent administrative agencies from enforcing principles despite absence of any relevant law. *See SEC v. Chenery*, 332 U.S. 194 (1947) (subject to limitations of retroactivity, allowing SEC to enforce principle against inside ownership of public utility company despite absence of any specific rule). But the Administrative Procedure Act further seals such maneuvers by requiring agencies to codify and publish all promulgated laws. *See* 5 U.S.C. 5529(a).

[61] See Re Canadian Tire Corp. (1987), 10 OISCB 857; Committee for the Equal Treatment of Asbestos Minority Shareholders v. Ontario [Securities Commission], [2001] 2 SCR 132; see also CONDON, ANAND & SARRA, supra note 37, at 605 ("It is in the discretion of the regulator to interpret the public interest in accordance with its statutory

invoking the "public interest power" and suggests a principles-privileged enforcement environment. It can provoke cries of unfairness for its failure to give notice of applicable law.[62]

In its SOX 108 Study, the SEC opined that "objectives-oriented standards . . . may serve to better facilitate efforts to enforce compliance with the standards. . . ."[63] This belief is attributed to how such standards repose less discretionary judgment in actors making decisions. It contrasts with both a rules-based and principles-only stance. In rules-based systems, actors have essentially no discretion. These become the easiest targets to enforce compliance. One either complied or did not, determinable by comparing the rule to the action. At the opposite extreme, vague general principles lack the same determinability. Observers wonder if the actual standard is the ex post and ad hoc judgment of the enforcer.

This three-part classification presents a basis for criticizing innovations such as the British Columbia principles experiment. It is a two-pronged point. First, enactment of a principles-based legal regime vests considerable discretion in regulated actors, yet may be unaccompanied by sufficient guidance for conduct. True, a principles-based framework is designed to provide more guidance than what the SEC called a principles-only system. But suppose regulators have power to enforce violations of principles despite absence of any rule violation. Combining this with a principles-based (if not principles-only) system can create excessive uncertainty and credible charges of ex post regulatory arbitrariness.

Notably, unlike other provinces, British Columbia law does not allow regulatory enforcement under the public interest powers principle.[64] There, regulatory enforcement requires violation of stated law. It is therefore especially striking that British Columbia would propose a written law characterized as principles-based. It achieves through the back door what other provinces enjoy through the front door - and for which they face considerable criticism. With a written principles-based law, regulators have a wide range of enforcement options available, despite lacking authority to invoke the public interest power. While such principles as "continuous disclosure" are less general than a principle of the public interest, a conscious regulatory move towards principles rather than rules should signal some concern.

---

mandate [and] making orders in the public interest does not require a breach of securities law") (citing Harper (Ontario Securities Commission 2004)).

[62] *See* Mary Condon, *The Use of Public Interest Enforcement Orders by Securities Regulators in Canada*, RESEARCH STUDY FOR THE WISE PERSON'S COMMITTEE (Oct. 24, 2003).

[63] SEC SOX 108 STUDY, *supra* note 11.

[64] CONDON, ANAND & SARRA, *supra* note 37, at 616 ("It should also be noted that the application of an administrative penalty by regulators in British Columbia requires a contravention of the law.").

Concerns about this maneuver may be influenced by the enforcement policy of the authority promulgating them.[65] The British Columbia materials explaining the proposed regime boast that "B.C. leads the country in the number of enforcement actions compared to Ontario, Alberta and Quebec [sic]."[66] This suggests a conceit that the number of enforcement actions should be accepted as a tribute to enforcement effectiveness. While possible, it is at least plausible that fewer or declining numbers of actions represent success.

The British Columbia materials further state that many provisions from its existing law are continued substantially unchanged in the proposed legislation and that these account for 92% of the province's recent enforcement actions.[67] Carrying over the most enforced laws raises questions about the significance of a switch from a rules-based system to this principles-based system. It could suggest correction of something that was not broken. If old provisions are carried over because they are principles, one wonders about the prior distribution of enforcement actions being biased towards principles. For those that are rules-based, one wonders if jettisoning them is desirable. Their existence might have helped to instantiate norms, manifested in the absence of rule violations requiring enforcement. Repealing them could erode those norms.

Returning to the structure of administrative law enforcement, contrast this structure with the traditional equity versus law distinction. In equity, the scene involves enacted positive law as rules, mediated by reflective judicial application of principles. This structure is supported and legitimized by separation of powers concepts, with legislative pronouncement, executive (or private-party) enforcement, and judicial balancing. While such a tripartite framework can be used in securities law enforcement, it is not a common structure.

Rather, in administrative law enforcement, the common fact pattern involves a regulator acting as promulgator, enforcer, and evaluator.[68] This overlapping combination of roles leads to questions and criticisms - and considerable current debate across Canada as to the provincial securities commissioners.[69] Canadian law allowing enforcement of the broad "public interest power" principle despite compliance

---

[65] *See Ainsley Fin Corp. v. OSC* (1994), 28 Admin. LR (2d 1); Mary Condon, *Power Without Responsibility or Responsibility Without Power?*, 10 BANKING AND FINANCE L. REV. 221 (1995).
[66] British Columbia Securities Commission, *Questions and Answers on New British Columbia Securities Act*, SBC 2004 c 43, at 6.
[67] *Id*.
[68] *See* Tamar Frankel & Lawrence A. Cunningham, *The Mysterious Ways of Mutual Funds: Market Timing*, 25 BU ANN. SURV. FIN. & BANKING L. ___ (forthcoming 2006).
[69] *See* Puri, *Enforcement Effectiveness in the Canadian Capital Markets*, *supra* note 1.

with rules is a powerful device supplementing this already powerful structure. A regime without such power moving towards a "principles-based" law raises identical concerns.[70]

Reposing rulemaking and enforcement power in a single agency thus creates potential conflict between a rules-based versus principles-based framework. True, enforcement can simply focus on rules but it rarely stops there. Enforcement expands the regulatory scope beyond the rules on the books. The enforcement question is thus tied to the rules versus principles decision. How is or should enforcement be pursued, given the existence of rules but the temptation to enforce coexisting principles? This invites assessing enforcement activity and effectiveness, to which the next Part is addressed.

4. Practice and Results

This Part considers whether there are differences, as between Canada and the U.S., in the distribution of enforcement activity among securities laws residing towards the rules or principles ends of that continuum. It also considers the bearing of such a distribution on the relative effectiveness of securities enforcement. The Part is divided into three Sections. Section i. is dubbed public enforcement, designating the SEC in the U.S. and those of the provinces and tribunals throughout Canada reported under the CSA's auspices; Section ii. is called professional enforcement, designating the NASD in the U.S. and the IDA in Canada; and Section iii. contains brief reflections on private enforcement, noting how the complexities of that context differ considerably from those of public and private enforcement.

i. Public: SEC and CSA

In the U.S., Congress has substantially pre-empted state law concerning securities regulation in all but some narrow corners (having mainly to do with state blue sky laws and common law fraud actions, including activity such as insider trading and mutual fund market timing).[71] Congress authorizes and designates the SEC to promulgate additional laws administratively and to enforce those laws (along with the Department of Justice for criminal matters). State attorneys general and private plaintiffs supplement the enforcement function for some areas of law.

[70] True, there is some judicial superintendence, but this is not always accessed and invariably is costly.
[71] *See* Joel Seligman, *The United States Federal-State Model of Securities Regulation*, in A. DOUGLAS HARRIS, ED., WPC—COMMITTEE TO REVIEW THE STRUCTURE OF SECURITIES REGULATION IN CANADA: RESEARCH STUDIES (Ottawa: Department of Finance, 2003).

The SEC uses an integrated structure in both promulgating and enforcing U.S. federal securities laws. The SEC initiates approximately 1,000 investigations annually, covering a consciously determined broad range of subject matters.[72] The SEC has long classified its enforcement program according to the following categories: financial disclosure; broker-dealer, investment advisor or investment company; securities offerings; insider trading; and market manipulation. Enforcement allocations generally are intended to cover the full range of these core enforcement areas. SEC policy repeatedly states that this distribution of enforcement activity is necessary to deter securities law violations effectively - and uses it as a measure of enforcement effectiveness.[73]

In addition to the stated SEC policy, in given years enforcement subject areas vary due to episodic market developments. For example, during 2003 and 2004, widely publicized research analyst conflicts of interests scandals led the SEC to pursue more broker-dealer enforcement proceedings during those years than in 2005 (20% and 22% compared to 15%), while the 2005 mutual fund market timing scandals led it to slightly greater enforcement against investment advisors in 2005 compared to 2004 and 2003 (16% compared to 14% and 11%).[74] The outbreak of major financial frauds during 2002 and 2003 resulted in a sizable upswing in the level and scope of SEC enforcement activity concerning financial disclosure in both those years compared to prior and later years.[75]

---

[72] *See*, *e.g.*, SEC Annual Report (2005) (SEC's summary of its enforcement program for FY2005 notes initiated 947 investigations, 335 civil proceedings and 294 administrative proceedings); SEC Annual Report (2004) (noting initiating approximately 950 investigations). The number of contemporary enforcement actions is double that of a decade ago, although the distribution of actions by type has remained substantially the same. *See* McLucas, Taylor, & Mathews, *supra* note 49 (mentioning 500 annual investigations but offering a distribution akin to contemporary SEC reports).

[73] *See* SEC Annual Report (2005), at 8, which states as follows:

> Effective deterrence of securities fraud requires that the cases filed by the SEC have adequate reach across all core enforcement program areas. The mix and types of cases change from year to year based upon the conditions of the markets and the changes in financial instruments being used. The SEC's enforcement program seeks to maintain a presence and depth so that no single area dominates its case mix, nor is underrepresented. This measure [of performance, summarized in the table below in this report] evaluates whether the Commission maintains an effective distribution of cases so that no category exceeds 40% of the total.

See also SEC Annual Report (2004), at 25 (noting in connection with performance measure of enforcement cases successfully resolved that "the SEC strives to bring cases that are as strong as possible but, at the same time, aims to file large, difficult or precedent-setting cases when appropriate, even if success is not assured").

[74] *See* SEC Annual Report (2005) (historical chart); *see also* SEC Annual Report (2004) (in enforcement highlights section, noting 29 actions against mutual fund participants).

[75] *See* SEC Annual Report (2003) (highlighting 9 financial disclosure cases, including concerning Enron and Xerox plus those at Brightpoint, TV Guide, HealthSouth, and Qwest); SEC Annual Report (2002) (highlighting 14 financial fraud and disclosure cases, including Dynergy, Tyco, Enron, Adelphia, WorldCom, Rite Aid, Microsoft, Xerox, among others); *compare* SEC Annual Report (2004) and SEC Annual Report (2005 (both highlighting other enforcement areas far more prominently than financial disclosure).

In contrast to the substantially integrated U.S. structure, with the vast majority of enforcement power exercised by the SEC, Canada's securities regulation framework is fragmented in structure. Laws are promulgated by the 13 provinces and territories and enforced by commissions and tribunals of the respective regions.[76] Each province uses governmental securities commissions or administrators to oversee respective provincial securities Acts. These Acts are distinct sets of laws and regulations that regulate market participants. These vary among the provinces, although not in broadly radical ways that prevent classifying particular subject matters along a rules-principles continuum.[77] Still, in Canada, no single integrated authority can make or execute broad enforcement policy the way the SEC does.

To promote national consistency and harmonization of securities regulation across Canada, provincial securities commissions and administrators formed a national group, called the Canadian Securities Administrators (CSA). CSA aspires to provide a coordinating function, manifested, in part, through its semi-annual reports of enforcement actions that collate actions from across the provinces.[78] This is part of a broad dialogue and debate within Canada concerning the need for national coordination in securities regulation.[79]

Currently, CSA classifies provincial securities law enforcement actions according to the following categories: disclosure; misconduct by registrants; illegal distribution; insider trading; and market manipulation. Ensuing analysis uses these classifications without attempting to untangle particular cross-

---

[76] *See* DAVID JOHNSTON & KATHLEEN DOYLE ROCKWELL, CANADIAN SECURITIES REGULATION (3d ed. 2003) at xxxvii ff. ("Table of Concordance"); CONDON, ANAND & SARRA, *supra* note 37 (providing statements throughout of specific variation across Canadian provinces). This is not to say that Canadian securities law is uniform across the Provinces, which it is not. For example, "there is no uniform definition of material fact in securities statutes across Canada. Moreover, what is 'material' within the meaning of the legislation is sometimes contested. . . ." *Id*. at 265. Ontario and New Brunswick define material fact as one "that would reasonably be expected to have a significant effect on the market price or value of the securities." *Id*. Alberta, Nova Scotia, Saskatchewan, Newfoundland and Labrador and Prince Edward Island define it as: "fact that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of the securities." *Id*. In Quebec, the issue is whether a fact is "likely to affect the value of the market price of the securities. . . ." *Id*. But variation is not so strong as to prevent classifying the subject matters along the rules-principles continuum (and variation supports the claim that it is foolhardy to classify a country's laws as principles-based or rules-based and supports the idea that such concepts reside upon a continuum).

[77] *See* CONDON, ANAND & SARRA, *supra* note 37, at p. 16 (Ontario's Securities Act has remained mostly unchanged since 1978, although in 1994 it added statements of specific objectives the law should meet and numerous principles that elaborate the objectives, OSA, §§ 1.1 & 2.1, and other provinces follow the Ontario model "very closely"). The securities commissions delegate aspects of securities regulation to the IDA and other SROs, the Mutual Fund Dealers Association of Canada, Market Regulation Services Inc., and the exchanges. *See* Section 4.B, *infra*.

[78] These "Reports on Enforcement Activities" cover periods from April 1, 2004 to September 30, 2004 [hereinafter called CSA No. 1]; October 1, 2004 through March 31, 2005 [hereinafter called CSA No. 2]; and April 1, 2005 to September 30, 2005 [hereinafter called CSA No. 3].

[79] *See* CONDON, ANAND & SARRA, *supra* note 37, at 141-42; A. DOUGLAS HARRIS, ED., WPC—COMMITTEE TO REVIEW THE STRUCTURE OF SECURITIES REGULATION IN CANADA: RESEARCH STUDIES (Ottawa: Department of Finance, 2003); Puri *Enforcement Effectiveness in the Canadian Capital Markets*, *supra* note 1.

province variation - which while existent is not overwhelming and most is attributable to regional or local demographic factors in much the way that SEC actions are influenced by local factors assessed by the SEC's regional offices.[80]

Case Types

In considering comparisons between the SEC and CSA enforcement actions, note that case categories the two use align substantially although inexactly. Both include categories called insider trading and market manipulation but other categories use different descriptions: the SEC uses securities offerings while CSA uses illegal distribution; the SEC uses financial disclosure while CSA uses disclosure; and the SEC uses broker dealer and investment advisor (and reports these separately) while CSA uses registrant misconduct (registrant being the term used to designate brokers, dealers and funds in Canada while the word "issuer" is used to describe the equivalent of a U.S. "registrant").

Despite these descriptive variations, a review of the cases so classified indicates considerable substantive overlap among the categories.[81] Accordingly, they should be sufficiently meaningful to permit cross-border comparisons by types of laws and by aggregate enforcement activity and effectiveness across categories.[82]

To classify these subject areas along the rules-principles spectrum ideally requires essentially a two-step process. First, one can locate each case type along such a continuum according to the broad substantive character of the laws encompassed within each. Second, one can inquire into the specific examples of the kinds of enforcement actions brought within each case type to refine the degree to which enforcement activity pursues a rules or principles orientation within given categories.[83] The following discussion

---

[80] Condon, *The Use of Public Interest Enforcement Orders by Securities Regulators in Canada*, *supra* note 62 (study of public interest enforcement power showed some usage differences but not all that much); Charles River Associates, *Securities Enforcement in Canada: The Effect of Multiple Regulators*, in A. DOUGLAS HARRIS, ED., WPC—COMMITTEE TO REVIEW THE STRUCTURE OF SECURITIES REGULATION IN CANADA: RESEARCH STUDIES (Ottawa: Department of Finance, 2003) (study showed some differences between, for example, Manitoba and Ontario but attributable to local needs). The SEC's regional office structure as likely results in similar intra-U.S. distribution variation although the SEC Annual Reports do not break the actions down that way. *See also* Seligman, *supra* note 71 (U.S. federalism in securities regulation).

[81] *See* Appendix A.

[82] This is thanks to CSA's recent efforts at providing this classification. *Compare* Charles River Associates, *Securities Enforcement in Canada*, *supra* note 80 (study made before such classifications were available was limited in its comparative efficacy).

[83] This two-step approach may be especially useful to examine contexts in which the population of laws bears both principles-based and rules-based qualities to determine whether enforcement activity concentrates on one or the

pursues the first point; Appendix 1 provides detailed descriptions of illustrative cases by category that support the more general conclusions stated below.

As to the broad content of the law within each category, toward the rules end of the spectrum are the vast bulk of both Canadian and U.S. law governing securities offerings (U.S.) and amounting to illegal distributions (Canada). The main laws implicated in these contexts in both countries are rules - such as requirements for entities and securities to be registered and the latter to be described in a circulated prospectus, in each case subject to exemptions and exceptions to the exemptions. In Canada, moreover, there are broadly three different legal frameworks governing prospectus delivery requirements and associated exemptions, variously adopted across the provinces. All are best described as intensely rule-like.[84]

Also towards the rules end of the spectrum are the laws governing securities firms.[85] These are mostly rules-based but tinged with an overlaying texture best described as principles-based. Main examples of broker-dealer *rules* are: net capital rules,[86] customer protection rules,[87] books and records and reporting rules,[88] credit extension rules,[89] short-sale rules,[90] trading practices rules,[91] and rules governing contingency offerings.[92] These rules are supplemented by broad antifraud principles of both general applicability[93] and tailored to the broker-dealer context by prohibitions on misappropriating customer funds or securities, unsuitable or unauthorized trading, churning, and charging excessive markups.[94]

---

other. It also may be useful for populations dominated by principles or rules but that involve significant enforcement actions that concentrate on the smaller portion of those laws.

[84] *See* CONDON, ANAND & SARRA, *supra* note 37, at 303 (noting three different legal frameworks followed by Quebec, Ontario, and the rest of Canada and citing BORDEN LADNER GERVAIS, SECURITIES LAW AND PRACTICE as containing 26 pages of summary detail on various exemptions); *see also* CONDON, ANAND & SARRA, *supra* note 37, at 339 (detailing implications of incorrect reliance on prospectus exemptions).

[85] The SEC collects related cases under the headings of broker-dealer and investment advisor or company and CSA collects them under the heading registrant misconduct.

[86] 17 C.F.R. 240.15c3-1 (include specifying methods of computing net capital).

[87] Exchange Act Rules 15c1-2, 15c2-2 (17 C.F.R. 240.15c1-2, 240.15c2-2).

[88] *Id*. 240.17a-3 to 17a-11 (broker-dealer must maintain possession and control of margin customer securities and may not use customer funds to finance operations other than customer transactions).

[89] *See*, *e.g.*, Regulation T, 12 C.F.R. 220.1 to 220.132.

[90] 17 C.F.R. 240.10a-1.

[91] *See* Regulation M, 62 Fed. Reg. 520 (codified at 17 C.F.R. 242); Rules 101, 102, 62 Fed. Reg. 520, 546-548 (codified at 17 C.F.R. 242.1-10243.102).

[92] 17 C.F.R. 240.10b-9,240.15c2-4.

[93] *See* Exchange Act 10(b), 15 U.S.C. 78j and Rule 10b-5, 17 C.F.R. 240.10b-5; Securities Act 17(a), 15 U.S.C. 77(1).

[94] Rules 15c1-2, 15c2-2 under the Exchange Act, 17 C.F.R. 240.15c1-2, 240.15c2-2.

Toward the principles end of the spectrum, both countries' insider trading laws boil down to trading while in possession of non-public information when occupying some capacity of trust or other special relationship.[95] In fact, the SEC's insider trading enforcement program is the dominant example of the SEC's use of an ad hoc enforcement approach.[96] The SEC began this program in the 1980s with great vigour, despite there being no law defining this violation. Through that program, the SEC even increased its power to enforce such principles-based violations by developing new legal theories of misappropriation.[97]

While the laws of these countries governing insider trading are not necessarily the same, they seem fairly describable as principles-based and the articulated principles invoke similar concepts and apparently intended meanings.[98] This is so despite how in the U.S. the concept of insider trading and its prohibition are not set forth explicitly in statute or regulation while in Canada most provincial securities acts state the prohibition and define it explicitly, along with various exemptions or defences (also principles-like, such as reasonable belief that information had been generally disclosed or reasonable mistake of fact).[99] Across Canada, moreover, the law governing such defences and exemptions often involves applying a principles-oriented factors test.[100]

The concept of market manipulation is also a broad principle in the U.S..[101] Section 9 of the Exchange Act prohibits "manipulation of security prices."[102] Section 9(a)(2) makes it unlawful for any person to effect

---

[95] Canadian provinces may so provide in statute (as in British Columbia and Ontario). *See* CONDON, ANAND & SARRA, *supra* note 37. Courts construe various statutory terms. *See Pezim v. British Columbia (Superintendent of Brokers)* [1994] 2 SCR 557; *Re Donnini* (2002), 25 OSCB 6225. United States laws (both federal and state) are products of judicial development and elaboration of even broader, more principles-like, anti-fraud laws (such as 10b-5 at the federal level and fiduciary duties at the state level). *See United States v. O'Hagan*, 521 U.S. 642 (1997); Pitt & Shapiro, *supra* note 45.

[96] Pitt & Shapiro, *supra* note 45, at 156-157.

[97] *Id*. at 200-212 & 227-236.

[98] *See In re Finkelstein* (Canadian hearing panel struggling with whether alleged violations of U.S. 10b-5 insider trading law constituted action detrimental to the public interest in Canada).

[99] *See* CONDON, ANAND & SARRA, *supra* note 37, at Ch. 8.

[100] *See id.,* at 453 (as to determining whether information was generally disclosed or dissemination adequate, "Tribunals and courts regard a variety of factors, including the information, the type of security, the issuer, the medium adopted for communicating the information, and any alternative disclosure methods.").

[101] In the context of underwritten offerings it bears specific technical meaning. Despite the prohibition on market manipulation, Section 9(a)(6) of the Exchange Act also expressly permits market stabilization, a form of manipulation entailing "the buying of a security for the limited purpose of preventing or retarding a decline in its open market price in order to facilitate its distribution to the public." SEC, Exchange Act Release No. 2,446 (March 18, 1940). This exception is designed to permit underwriters when selling new or additional securities at the market price to prevent it from dropping to a level that would eliminate any incentives of underwriters to offer securities. The limitations on market manipulation are stated in the SEC's Exchange Act Rules 100-102 of Regulation M (called trading practice rules) with stabilization exceptions stated in Rule 104 thereto. *Compare supra* note 36 (Regulation M illustrating difficulty of moving from rules to principles).

transactions "creating actual or apparent trading activity . . . or raising or depressing [its] price . . . for the purpose of inducing the purchase or sale of such security by others". All U.S. market manipulation rules stem, in turn, from Exchange Act Section 10(b)'s principle proscribing "manipulative or deceptive devices or contrivances" within that general anti-fraud provision.[103] Canada's market manipulation laws bear similar attributes of principles, hinging on the open-textured concept of fraud. This orientation is reflected in how the CSA defines a category of cases under the single heading "market manipulation and fraud".[104]

Of mixed rules-principles character are the disclosure laws in both countries. General disclosure laws associated with concepts of materiality are principle-like. Laws governing the timing of filing related disclosure materials are rule-like. Disclosure concerning financial matters may bear attributes of rules or principles according to the qualities of the related accounting standard. The SEC offers a typology, summarized above in Section I.A, and illustrates the categories by characterizing certain accounting standards as rules-based[105] or principles-based[106] (along with a handful dubbed principles-only).

Apart from the foregoing major categories of securities law subjects, there are several additional categories of lesser pervasiveness but equal importance when they do arise. This includes proxy regulation, tender offers, short-swing profits and others.[107] These may not be routinely or emphatically enough emphasized in SEC or CSA enforcement actions to warrant classification categories in their respective reports. Many of these reflect essentially specialized applications of laws contained in the broader categories, along with an additional mix of laws variously arrayed along a rules-principles continuum. Some offer particularly good illustrations of points along that continuum. For example, the

---

[102] Section 9(a)(2) refers to listed securities and courts have extended anti-manipulation law to all securities in all securities markets by interpretation of Section 17(a) of the Securities Act and Rule 10b-5 under the Exchange Act. *See* COX, HILLMAN & LANGEVOORT, *supra* note 37, at 315.

[103] Much of the SEC vocabulary across a variety of enforcement contexts imagines that the battle is always against fraud. *E.g.* SEC Annual Report (2005), at 8 (explaining that overall enforcement program must reach across *all areas* to achieve "Effective deterrence of securities *fraud* . . . ") (emphasis added).

[104] CSA Nos. 2 and 3 include fraud with the market manipulation category whereas CSA No. 1 described the category simply as market manipulation.

[105] SEC SOX 108 Study, *supra* note 11 (examples of Real Estate Sales, Receivables Transfers, Investments, Derivatives, Leases, Pensions, Retiree Benefits, Stock Options, Income Taxes).

[106] SEC SOX 108 Study, *supra* note 11 (examples of SFAS 52 Foreign Currency Translation, SFAS 34 Interest Capitalization, SFAS 142 Intangible Assets, SFAS 143 Asset Retirement Obligations, SFAS 144 Long-Lived Asset Impairment, ARB 43, Ch. 4 Inventory, SFAS 141 Business Combinations, SFAS 146 Restructurings).

[107] Short-swing profit violations could be included within the insider trading category but they are quite a different sort of rule, violation and enforcement—although when CSA cases talk about insider reports it appears that they have an affinity to this concept.

SEC's tender offer regulations determine whether a tender offer occurs according to an 8-factor list of attributes.[108]

A similarly broader range of subjects appears in Canadian securities regulation and likewise may exhibit such attributes. Examples include how violations in each of the substantive categories can be accompanied by violations of laws requiring cooperation with authorities. For example, CSA reports under the heading Insider Trading cases involving making false and misleading statements to staff during insider trading investigations.[109] Likewise, disclosure violations include failure to provide information to compliance officers[110] and securities firm violations include disobeying regulatory orders or not cooperating with authorities.[111] However, both the SEC and CSA classify all such cases in their categories called Other and Miscellaneous, so the present study does not attempt to classify them further.

With these case classifications made, we can consider their relation to enforcement activity and effectiveness. This requires distinguishing between the two and poses some measurement challenges. Enforcement *activity* is deploying resources (including budget and staff) to pursue potential and actual violations of securities laws.[112] The issue is whether activity is allocated more towards violations of rules or principles and whether legitimate reasons support the allocation. Enforcement *effectiveness* is the degree to which objectives are achieved. These include efficient and fair capital markets uninfected by violations that impair those attributes or impair investor confidence or investor protection - actually measuring effectiveness so conceived is a formidable task, requiring analytical proxies.

The next sub-section considers enforcement effectiveness. This sub-section considers enforcement activity, beginning with the distribution of enforcement actions across the foregoing subject matters as located on the rule-principles continuum. The following table, extracted from recent SEC and CSA reports, uses the foregoing classifications to summarize the percentage of SEC and CSA enforcement

[108] *See SEC v. Carter Hawley Hale Stores Inc*., 760 F.2d 945 (9th Cir. 1985).
[109] *Gregory Hryniw and Walter Hryniw* (Ontario, CSA No. 3, at 10).
[110] *Portus Alternative Asset Management Inc. & Portus Alternative Asset Management and Boas Manor* (New Brunswick, CSA No. 2 at 14); *ATI Technologies Inc.* (Ontario, CSA No. 2 at 15).
[111] *Northern Securities Inc*. (British Columbia, CSA No. 1, at 18); *Derivative Securities Inc. and Malcom Robert Bruce Kyle* (Ontario Superior Court, CSA No. 3, at 15) (characterizing non-cooperation as conduct unbecoming); *Christopher Robinson* (Nova Scotia, CSA No. 3, at 19).
[112] *E.g*., SEC Annual Report (2004), at 12 (noting that 53% ($399 million) of the SEC's budget is allocated to enforcement).

actions in recent years bearing dominantly rule-like and principle-like qualities (and those of a more completely mixed nature).[113]

SEC and CSA Enforcement Action Distributions

	Case Type	SEC	CSA
RULE-LIKE			
	Securities Firms	32.0%	32.0%
	Offerings/Distributions	12.5	27.0
PRINCIPLE-LIKE			
	Insider Trading	7.5	9.0
	Manipulation/Fraud	6.0	12.0
MIXED			
	Disclosure	28.5	10.0
	Other	10.0	10.0

In terms of relative enforcement activity directed towards the rules or principles end of the continuum, a threshold point is how these actions partake of portions of the overall body of securities law in the countries. These may collectively be denominated as more or less rules- or principles-like. The distribution of enforcement actions across the reported categories would need to be compared to that population of laws. Otherwise, results could be skewed (for example, a country could articulate all but a few laws in the form of principles yet concentrate all its enforcement activity on rules-oriented violations). However, the foregoing review of U.S. and Canadian securities laws does not support the proposition that one or the other is more heavily principles-based or rules-based.[114] Accordingly, the

[113] Canadian data are derived from 3 half-years beginning with April 1, 2004 and ending September 30, 2005, reported in CSA's semi-annual Reports on Enforcement Activities. SEC data are derived from the SEC's fiscal years 2003, 2004 and 2005, reported in its 2005 Annual Performance and Results Report. A review of SEC prior years' annual reports indicates some but minor variation in the mix, much of the variation being attributable to prevalent publicly known scandals or crises, such as research analysts, mutual fund market timing, or financial reporting scandals. This consistent distribution, punctuated according to prevailing securities industry conditions, has held for more than a decade. *See* McLucas, Taylor, & Mathews, *supra* note 49, at n.74; *see also* Charles River Associates, *Securities Enforcement in Canada*, *supra* note 80, at 488 (table of SEC investigations for 2002 showing similar distribution with some variation compared to the data presented below). For the SEC, statistics in the table are arithmetic averages of the ranges reported in the surveyed Annual Reports. The SEC category of securities firms includes actions against both investment advisors and companies and securities brokers and dealers, which the SEC Annual Reports classify separately. For CSA, data are based on examining all cases reported in the Study Period. These are listed in Appendix C.

[114] *See also* Appendix A.

underlying pool of law is sufficiently similar that the distribution of enforcement actions is a useful basis for comparing enforcement activity.[115]

As to characterizing the subject matter categories as principles-like or rules-like, the foregoing discussion provides a reasonable basis for the classifications assigned.[116] This organization of actions suggests that SEC enforcement activity congregates somewhat more heavily on rules-based enforcement compared to principles-based enforcement (44.5% to 13.5% or 3.3:1 with another 28.5% of mixed character). In slight contrast, the CSA data show a less pronounced but still real rules-based enforcement bias (59% to 21% or 2.8:1 with another 10% of mixed character).[117]

Within the categories denominated as mixed, the SEC's caseload concerns predominantly financial accounting and these are mainly principles-based;[118] CSA's disclosure category, deemphasizing accounting, is heavily rules-based (*e.g.*, it is heavily dependent on questions such as whether a filing was made or not made).[119] Taking these points into account, the SEC incrementally tends to enforce more cases of principles-like laws compared to CSA's slight relative enforcement emphasis on rules-like laws. But this is a close call as between the SEC and CSA.[120] In any event, these data do not support the conclusion that there is any material difference, as between the SEC or CSA, in the distribution of enforcement actions invoking rules versus principles.

The two also show strong similarities in terms of the relative distribution of actions across subject matters, although here some important differences appear. As for similarity, first, substantially equivalent enforcement allocations appear in the two countries as to both insider trading and securities firms as well as in the other/miscellaneous categories. Second, the Canadian allocation is somewhat greater in the area

---

[115] The countries differ vastly in scale. The data reflect that CSA authorities collectively prosecute a much smaller number of actions compared to the SEC, reflecting relative size. Hence they appear in the table as percentages rather than raw figures. Canada's relatively smaller size enables researchers to examine a more complete sampling of CSA actions for most subject matter categories, including for this Research Report. It is certainly possible for a study to review every SEC enforcement action taken annually, but as a practical matter that is not possible in the context of the current study—nor is it necessary to develop the analytical contributions it offers.

[116] *See also* Appendix A (probing this more specifically).

[117] Discussion omits the Other category, recognizing how the data could be affected depending upon the content of cases included in that heading. One way of handling this limitation is to rank the categories instead of using absolute numbers, although this would be a more important limitation if the category contained much more than the 10% it does in both countries. *Compare* Charles River Associates, *Securities Enforcement in Canada*, *supra* note 80, at 485 (using ranking system given that Manitoba Other category was 66%).

[118] *See* Appendix A, Section 5.

[119] *See id.*

[120] More pronounced variation appears as between the SEC/CSA on the one hand and NASD/IDA on the other. *See infra* Section 4.B.

of market manipulation and fraud.[121] The major differences are the essentially inverse allocations to disclosure and illegal distributions. Disclosure enforcement is much higher in the U.S. than in Canada;[122] illegal distribution enforcement is much higher in Canada than in the U.S..[123]

Among possible explanations for these differing distributions are demographic factors. While both countries are well-developed industrial nations with considerable depth in capital markets and related investment sophistication, they also differ considerably in size and demographics. For example, U.S. securities markets boast thousands of large, seasoned issuers whose securities are widely held, often through mutual funds and other intermediaries. In contrast, Canadian securities markets boast fewer than 200 such issuers plus a very large number of smaller issuers and a sizable number of issuers with controlling shareholders.[124] This could justify how the SEC allocates comparatively more enforcement activity to disclosure and Canada to distributions.

Results

Selecting appropriate measures or a framework for assessing enforcement effectiveness is difficult. A sensible starting point is the metrics the regulators themselves use. This speaks to the self-conception of the enforcers - and incentives (since you manage what you measure). All use or report specific metrics such as cases opened and closed and success rates in terms of remedies (injunctions, suspensions, bans, fines collected).

The SEC's annual reports identify more elaborate performance measures in accordance with the Government Performance and Results Act of 1993.[125] The 2005 report summarizes performance measures concerning enforcement. It begins by stating that the performance measures generally attempt to assess "how much activity the SEC conducts in a given fiscal year, how quickly it accomplishes its tasks, and

[121] This could be due to the SEC's equivalent category capturing only market manipulation without also including "fraud."
[122] True, despite the U.S. label being narrower as signified by the adjective "financial."
[123] Again, this assumes that the SEC's designation, securities offerings, is the functional equivalent of CSA's designation of illegal distributions.
[124] *See* Pillay, *Forcing Canada's Hand?, supra* note 38, at 298-99 (citing Christopher C. Nicholls, *Policy Comment: Canadian Responses to Sarbanes-Oxley*, CAPITAL MARKETS INSTITUTE, Jan. 2003, at 11-12)
[125] Pub. L. No. 103-62, 107 Stat. 285 (codified as amended in scattered sections of 31 U.S.C. and 39 U.S.C.). GPRA requires the U.S. Office of Management and Budget (OMB) to prepare and submit to Congress an annual overall governmental budget. In turn, the GPRA mandates that the Director of OMB require federal regulatory agencies to prepare subsidiary annual performance plans. These plans must, among other things, establish performance goals and indicators used to measure relevant outcomes. Its purpose was to encourage agencies to focus more outcomes rather than merely outputs. *Compare* Charles River Associates, *Securities Enforcement in Canada*, *supra* note 80, at footnotes 11-12.

what effects these activities have on the markets and investors."[126] It acknowledges that "measuring effectiveness is the most challenging" of these three and that the SEC's "impact can only be indirectly assessed".[127]

In 2004, the SEC instituted two new enforcement-related performance measures. The first is enforcement cases successfully resolved. The SEC emphasized that it prevailed in the great majority of enforcement actions decided by district courts or administrative law judges.[128] Successful regulatory outcomes could be a difficult rationale to defend if defined only in terms of "winning" cases. Such a measure could bias regulators away from important but challenging cases in favour of concentrating on routine and easy ones. That could imply an undue bias towards enforcement of rules and against principles.

One past SEC Chairman announced that enforcement effectiveness requires an agency to provide a significant deterrent effect.[129] Instrumentally, that means a positive settlement calculus. According to this Chairman, "the SEC has relied most effectively on a high volume of settlements to keep its enforcement program efficient and vigorous".[130] The program is effective, in this view, as long as defendants show a propensity to settle; if litigation were the standard SEC option, its program would "become less efficient, less successful and ultimately less visible".[131] Despite this policy opinion, recent SEC reports present total cases resolved, without separately presenting those settled.

Although a strategy driven by a desire to settle could bias the SEC towards enforcing recognized rules rather than contestable abstract principles, in general, the SEC does not appear to use this approach. While it routinely pursues cases with high success probabilities, it also consciously undertakes big, precedent-setting cases. These present uncertainties and reduced probabilities of success but on matters of such importance that it is worth taking the risk. Such cases may involve complex or novel applications of rules, but more likely involve application or interpretation of principles. This illustrates the agency acting on its safety valve of principles to address novelties or public debacles.

---

[126] SEC Annual Report (2005), at 27.
[127] *Id*.
[128] *Id*. at 25 ("Successfully resolved is defined as those parties against who the SEC successfully obtained an administrative order or a judgment by consent, by default, through summary judgment, or following a bench or jury trial").
[129] Pitt & Shapiro, *supra* note 45, at 171. Mr. Pitt wrote the cited article several years before being appointed SEC Chairman but at a time when he already had extensive experience appearing before the Commission as a private securities lawyer.
[130] *Id*. at 179.
[131] *Id*. at 181.

As to such matters, the SEC sometimes presents measures that appear to be particularly useful as proxies for that kind of enforcement effectiveness. For example, recent SEC reports use the number of domestic households investing in mutual funds. This could be relevant to testing the effectiveness of its enforcement activities addressing the mutual fund market timing scandal of the early 2000s. This involved enforcement by both state attorneys general and the SEC - both applying principles-like laws (there having been no or limited precise rules on the subject).[132]

Amid novel public debacles - from rampant insider trading of the Michael Milken years[133] to off-balance sheet charades in the Ken Lay days[134] - principles often are more effective enforcement tools than rules. The SEC's insider trading enforcement program received a big boost from the former episodes and led to a worldwide expansion of this enforcement tool, significantly improving capital markets globally.[135] SEC reports do not indicate any efforts to measure these effects, however.

On the other hand, public enforcers sometimes assert violations of principles while simultaneously promulgating new rules to prohibit or restrict the underlying conduct. This suggests a conscious scepticism of the efficacy of principles-based enforcement in such contexts. The SEC's post-Enron adoption of Regulation G and off-balance sheet rules reflect this anxiety.[136] It is an admission of enforcement ineffectiveness when relying solely upon a principle in the given context.[137]

The second effectiveness measure that the SEC introduced in 2004 is referrals from its examination division to its enforcement division. The former "strives to uncover serious potential deficiencies" and refer them to the enforcement division. This performance measure tracks the number of enforcement referrals arising from significant deficiencies so discovered.[138] This measure echoes the theme of pre-emptive enforcement, to which increasing attention appears in articulation of regulatory policy.[139]

Establishing policies that require internal controls (or capital adequacy rules) is a direct move towards promoting compliance. An enforcement program to match is a critical tool to bolster overall enforcement

---

[132] *See* Frankel & Cunningham, *supra* note 68.
[133] *See* JAMES B. STEWART, DEN OF THIEVES (1992).
[134] *See* KURT EICHENWALD, CONSPIRACY OF FOOLS (2005).
[135] *See* Utpal Bhattacharya & Hazem Daouk, *The World Price of Insider Trading*, 57 J. FIN. 75 (2002) (before 1990, 34 countries had insider trading laws and 8 countries had prosecuted persons under them; after 1990, 87 countries have the laws with 38 having prosecuted persons under them).
[136] *See supra text* following note 42.
[137] It also may reflect how novel conditions require principles-based enforcement but those same conditions entice rules-based regulation to identify and instantiate associated norms. *See supra text* accompanying notes 39-42.
[138] SEC Annual Report (2005), at 22.
[139] *See supra text* accompanying notes 39-40.

effectiveness measured by ultimate compliance. In and after SOX, internal control regulations changed from a more principles-oriented model to a far more rules-like model. Ensuing enforcement emphasis on internal controls attracts more enforcement activity towards rules. This occurs as a consequence of the new rules, however, not because it is independently more appealing from the standpoint of probabilities of success.

The SEC's 2005 annual report cites several SEC institutional goals, ranking as goal number one to "enforce compliance with the Federal securities laws".[140] The report uses the following measures to gauge results: (1) percentage of first enforcement cases filed within two years; (2) enforcement cases successfully resolved; (3) number of requests to and by foreign regulators for enforcement assistance; (4) investment advisors and investment companies examined; (5) distribution of cases across core enforcement areas; and (6) assets frozen abroad as a result of SEC coordination with foreign regulators (a new measure in 2005, attesting to globalization).

Of these measures, three are potentially relevant to the bearing that principles- and rules-like enforcement have on effectiveness.[141] The first two items - percentage of first enforcement cases filed within two years and enforcement cases successfully resolved - potentially contribute to bias one way or the other. If the regulator is interested in swift filings, this means shorter investigations which may bias selection towards more rules-like cases (such as securities offering) and fewer principles-like cases (such as insider trading).[142] An appetite for swift resolutions may produce the same bias, although it could attract enforcement to principles-based areas in which the SEC has a particularly distinguished track record (such as insider trading cases, enforced since the 1980s, but perhaps not mutual fund market timing cases, only recently and sporadically enforced).

The distribution of cases across core enforcement areas is the critical item in the SEC's list of effectiveness measures. This functionally neutralizes any principles or rules bias by testing the overall distribution of cases in terms of core areas rather than any other specific attribute. The SEC "seeks to

[140] SEC Annual Report (2005), at 37-38. Apart from enforcement, the goals are "2. Promote healthy capital markets through an effective and flexible regulatory environment; Goal 3. Foster Informed Investment decision making and Goal 4: maximize the use of SEC resources."

[141] Except in some highly attenuated ways, the following do not seem to bear on the relationship between rules versus principles and consequent enforcement effectiveness: (3) foreign regulatory assistance, (4) examinations or (6) assets frozen abroad. In an attenuated way, foreign assistance and freezes may hinge on perceived strength of SEC cases which may hinge, in turn, on the foreign entity's enforcement bias.

[142] *See* McLucas, Taylor, & Mathews, *supra* note 49 (discussing scope of investigation required for various kinds of enforcement actions, ranging from relatively straightforward efforts for rules-based categories such as securities firms or offerings and far more elaborate exercises for principles-based violations such as insider trading laws).

maintain a presence and depth so that no single area dominates its caseload, nor is underrepresented".[143] The SEC considers its enforcement program effective, in these terms, only when no category of cases exceeds 40% of the total.[144] The overall effect of this policy and measure is to promote enforcement of principles and rules - in rough proportion to their presence in the underlying population of laws.

CSA does not publicize conceptions of enforcement effectiveness in its semi-annual reports; nor do the particular provincial commissions or tribunals appear to do so. Such a step might be desirable, perhaps by looking for guidance to the U.S. GRPA that governs SEC reporting.[145]

Despite absence of such public information among CSA members, two interesting proxies are accessible. The first takes seriously the former SEC Chairman's emphasis on settlement probabilities as a measure of enforcement effectiveness. Thus one could consider the number of CSA settlement agreements compared to the total number of actions and how they are distributed across subjects along the principles-rules continuum. In a recent 18-month period, for example, CSA members entered into 98 settlement agreements while achieving other outcomes (court rulings, commission or tribunal decisions or appeals) in another 120 cases, for a 45% settlement rate in the overall total of resolved matters.[146]

By subject-matter, settlements as a percentage of the total were: 65% for insider trading; 53% for registrant misconduct; 40% for illegal distributions; and 29% for each of disclosure and market manipulation/fraud. While not conclusive, this suggests that CSA settlement agreements may be more likely in insider trading cases than in disclosure or market manipulation cases. By case-type along the rules-principles continuum, settlements as a percentage of the total were 49% for principles-type violations and 44% for rules-type violations. This suggests some potential variation in settlement probabilities for cases asserting principles-like violations, but the data are not overwhelming or conclusive on that point.

Second, consider the relation of remedies to a rules-based or principles-based enforcement violation.[147] For a rules-based violation, the remedy can deny the respondent use of any attributes of the rule or kindred rules whose violation triggered enforcement. This is a common resolution of Canadian

[143] SEC Annual Report (2005), at 8.
[144] *Id*.
[145] *See supra* text accompanying note 125 ff.
[146] *See* Appendix C for a list of matters, extracted from CSA Reports. The figures in the text exclude cases under the heading Miscellaneous since these are unclassified subject matters and elude even rough classification along a rules-principles continuum.
[147] *See* JOHNSTON & ROCKWELL, *supra* note 76.

enforcement cases.[148] Good examples are enforcement actions addressing violations of rules that are tied to exemptions. The regulator may contend that a party wrongly invoked an exemption from a rule (such as a seed capital exemption to the prospectus delivery requirement). Regulators may impose a sanction denying the respondent the future right to rely upon any asserted exemptions. Rules thus can help to pinpoint the appropriate enforcement remedy, enhancing effectiveness. This remedy is appealing to negate some of the other limitations of rules (i.e., laws that state principles and then provide exemptions, exceptions or limitations).

Among other remedies, it can be tempting to measure enforcement effectiveness by fines imposed. Notably, while the SEC's 2005 annual report does not list fines or penalties collected as measuring performance, its 2004 annual report did so. In its performance discussion, the SEC boasted that "more than [U.S.]$3 billion, a record amount in penalties and disgorgement, was ordered in cases brought by the SEC."[149] Wholly apart from whether fines are greater or lesser in rules- or principles-based enforcement, whether fines are a useful proxy for enforcement effectiveness depends on one's view of their deterrent effect. This is an unresolved debate, with devotees of a law-and-economics viewpoint seeing fine risks as part of rational calculations that actors make when deciding to obey or violate law[150] and socio-legal theorists doubting that actors make such rational calculations and instead appreciating a more fundamental human desire to comply.[151]

Despite the intellectual stand-off, it could be of interest to compute fines imposed in principles-based compared to rules-based enforcement as an additional proxy for enforcement effectiveness. While of interest within a country, however, differences between U.S. and Canadian law in the scope of such penalties and the actors targeted would significantly impair their comparative utility.[152]

---

[148] *Id*.
[149] SEC Annual Report (2004), at 25.
[150] *See* Raymond Paternoster & Sally Simpson, *Sanction Threats and Appeals to Morality: Testing a Rational Choice Model of Corporate Crime*, 30 L. & SOC'Y REV. 549 (1996).
[151] *See* Timothy F. Malloy, *Regulation, Compliance and the Firm*, 76 TEMPLE L. REV. 451 (2003).
[152] *See* Charles River Associates, *Securities Enforcement in Canada*, *supra* note 80, at 488 ("Total penalties are higher in the U.S. due to large restitution payments. Administrative penalties and fines are comparable, on average, between Canada and the U.S. However, when account is taken of SEC civil penalties and disgorgements of illegal profits along with U.S. state restitution, U.S. monetary penalties are ten times larger than average Canadian penalties, per CDN$10 billion GDP."); *see* Puri, *Enforcement Effectiveness in the Canadian Capital Markets*, *supra* note 1, at 26.

ii. Professional: NASD and IDA

NASD and IDA[153] are both trade associations. They are dubbed self-regulatory organizations (SROs) in their respective countries. This denotes how they are subject to oversight by official lawmaking bodies but receive considerable deference in supervising industry members through establishing and enforcing standards of conduct. Other SROs exist in both countries, including the major stock exchanges in each and other miscellaneous trade groups such as MFDA/MRS in Canada. But NASD and IDA are the dominant faces of the respective securities industry infrastructure in the two countries, so this study concentrates on them.

NASD was founded in the 1940s as an association of securities industry participants. NASD licenses securities industry participants, establishes written standards of conduct and investigates and imposes disciplinary sanctions for non-compliance.[154] Its staff numbers nearly 2000 persons and its budget exceeds U.S.$500 million. NASD's regulatory purview is enormous, with more than 5,000 member firms boasting some 100,000 branch offices and nearly 700,000 registered representatives.[155] Its enforcement program is accordingly ambitious, matching that of the SEC.[156] For example, it annually receives some 5,000 investor complaints and files some 1,400 disciplinary actions.[157]

IDA was formed in 1916 and today is one of the major SROs in Canada (the others being the MFDA and MRS). IDA is responsible for regulation of its members firms and monitors the bond and money markets. It sets standards for securities firms (including as to minimum capital requirements) and market operations; regularly monitors and examines them for compliance; and investigates and enforces violations. IDA has some 200 investment dealers as members that employ some 39,000 people.[158] Member regulation includes registration requirements, financial and sales compliance, and related enforcement with prosecutorial authority. It receives some 1,300 customer complaints annually and

[153] As of April 2006, the Investment Industry Association of Canada was formed. The IDA continues to operate as a self-regulatory organization whose mission is to protect investors, foster market integrity and enhance the efficiency and competitiveness of the Canadian capital markets.
[154] NASD also administers private-party disputes with industry members, processing some 8,000 arbitrations and 1,000 mediations annually. *Id*.
[155] NASD, http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=749&ssSourceNodeId=9 (last visited March 5, 2006).
[156] As with the SEC volume, this prevents review of all its cases as a practical matter for this study.
[157] *See* table below.
[158] IDA Web site.

follows through principally by making civil claims (in about 1/3 of those cases) along with small numbers of disciplinary actions and investigations.[159]

Case Types

The NASD Manual and IDA Rule Book each spans many hundreds of pages of detailed text.[160] Both are dense compilations of detailed rules that also contain some broad general statements - as the ensuing series of paragraphs sampling them will quickly attest. Despite such heavy articulation of rules, the vast majority of enforcement actions by NASD and IDA assert principles-based violations of commercial honour and conduct unbecoming, respectively. These exhortations provide as follows:

> NASD Rule 2110: A member, in the conduct of his business, shall observe high standards of commercial honour and just and equitable principles of trade.

> IDA By-law 29: [Covered persons] (i) shall observe high standards of ethics and conduct in the transaction of their business, (ii) shall not engage in any business conduct or practice which is unbecoming or detrimental to the public interest, and (iii) shall be of such character and business repute and have such experience and training as is consistent with the [foregoing standards].

Both SROs impose "suitability" standards, most of which are general principles-like expressions while containing some rule-like detail. IDA Regulation 1300.1 states that

> each member "shall use due diligence" to "learn and remain informed of the essential facts relative to every customer and to every order or account accepted" (sub-section (a)); "to ensure that the acceptance of any order for any account is within the bounds of good business practice" (sub-section (o)); and "to ensure that acceptance of any order from a customer is suitable for such customer based on such factors including the customer's financial situation, investment knowledge, investment objectives and risk tolerance" (sub-section (p)). IDA Regulation 1300.1(q) applies the latter mandate to members when recommending action to customers.

[159] *See* table below.
[160] The NASD also publishes a separate 110-page booklet called "Sanction Guidelines;" IDA process- related provisions appear in the Rule Book.

NASD Rule 2310, called "Recommendations to Customers (Suitability)," provides that: "(a) In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."[161] IDA expressly contemplates adequate supervision. IDA Policy 2 elaborates, across 14 pages, on minimum standards for establishing and maintaining procedures, delegation and education.[162]

NASD Rule 2510, Discretionary Accounts, prohibits transactions "which are excessive in size or frequency in view of the financial resources and character of such account." It forbids exercising "any discretionary power in a customer's account" without the customer's "prior written authorization" and the account accepted as discretionary by the member firm in a written authorization of a duly designated member.[163]

Both NASD and IDA provide broad but detailed statements of policy concerning advertisements, bearing both principles-like generality along with some highly-detailed rule-like requirements. IDA By-law 29.7 is a multi-page statement of specific rules concerning advertising, including a series of specifically defined terms. NASD Rule 2210, Communications with the Public, likewise contains a list of six defined terms, one of which, Independently Prepared Reprint, contains 11 detailed sub-parts.[164] NASD Rules

[161] Sub-section (b) continues: "Prior to the execution of a transaction recommended to a non-institutional customer, other than transactions with customers where investments are limited to money market mutual funds, a member shall make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer." Sub-section (c) qualifies: "For purposes of this Rule, the term "non-institutional customer" shall mean a customer that does not qualify as an "institutional account" under Rule 3110(c)(4)."

[162] It addresses, in turn, opening new accounts, branch office and home office account supervision (providing detail concerning both daily and monthly reviews), supervision of open accounts, futures and options accounts and discretionary and managed accounts, and also mandates establishing specified procedures to deal effectively with client complaints.

[163] The Rule requires that member to "approve promptly in writing each discretionary order entered and shall review all discretionary accounts at frequent intervals in order to detect and prevent transactions which are excessive in size or frequency in view of the financial resources and character of the account." Finally, the Rule elaborates two detailed exceptions to which it does not apply: discretion as to price or timing of a given order and certain bulk exchanges at net asset value of money market mutual funds so long as certain stated specific conditions are met.

[164] It elaborates through seven extensive sub-parts on required approval procedures and associated recordkeeping; an additional sub-part sets forth a detailed list of exclusions from the stated requirements. A further section, divided into two sub-sections, each containing another half-dozen sub-clauses, elaborates on standards governing the content of communications with the public and advertising and sales literature.

elaborate in further detail on research reports. NASD Rule 2711, Research Analysts and Research Reports, spans a dozen pages, elaborating a series of nine definitions, containing extensive detail.[165]

Both rulebooks limit permissible activities outside the scope of the securities business. NASD Rule 3030 provides: "No person associated with a member in any registered capacity shall be employed by, or accept compensation from, any other person as a result of any business activity, other than a passive investment, outside the scope of his relationship with his employer firm, unless he has provided prompt written notice to the member."[166] IDA By-law 18.14 permits members to engage in other gainful occupations on specified conditions, including that it be in a remote location where the representative is among the only investment dealer in town and that such "dual employment is not contrary to the provisions of the applicable securities legislation or any policy made pursuant thereto."

Finally - in this exhausting selection from these excruciatingly detailed rulebooks - both compel cooperation with the respective regulators. For example, NASD Rule 8210 requires members and employees to aid NASD and its staff in its investigations. Likewise, IDA By-law 19.5 grants IDA investigatory powers and requires member cooperation. Numerous IDA By-laws specify procedures relating to IDA investigations and hearings.[167]

As noted, despite the excruciating detail of the NASD and IDA rulebooks, the vast majority of professional enforcement actions in both regimes cite a single broad abstract principle, of commercial honour (NASD Rule 2110) or unbecoming conduct (IDA By-law 29.1). Actions sometimes also cite specific rules but the actions are striking for the ubiquitous invocation of the broad general principle of

---

[165] Detail includes restrictions on relationships between investment banking and research departments, restrictions on communications with the subject company, restrictions on research analyst compensation connected with any investment banking services transaction and imposing specific review procedures, expressly prohibiting promising favourable research, restricting personal trading by research analysts (subject to various limitations and exceptions) and imposing detailed disclosure requirements as to ownership and compensation matters, the meaning of any ratings used in research reports and the distribution of ratings by the firm as a whole and the valuation methods used to determine any price target reported. The Rule also requires general supervisory procedures to implement the Rule and firm policy. The Rule also contains express exceptions for small firms (those participating in 10 or fewer investment banking transactions and generating $5 million or less in related fees).

[166] It provides further that such notice shall be in the form required by the member. Activities subject to the requirements of Rule 3040 shall be exempted from this requirement." In turn, NASD Rule 3040 prohibits employees from engaging in private securities transaction except in accordance with detailed requirements of the Rule. These requirements include giving prior notice of such activities to the employer, in detail. The Rule distinguishes the requirements applicable to transactions for and without compensation.

[167] *E.g.*, IDA By-laws 20.42(1) & 20.43. NASD Rule IM-1000-1 provides: "The filing with the Association of information with respect to membership or registration as a Registered Representative which is incomplete or inaccurate so as to be misleading, or which could in any way tend to mislead, or the failure to correct such filing after notice thereof, may be deemed to be conduct inconsistent with just and equitable principles of trade and when discovered may be sufficient cause for appropriate disciplinary action."

professionalism. While NASD actions heavily emphasize Rule 2110, they also appear to capture a wide variety of other activity that is specifically addressed by particular Rules with numerous actions residing under a large number of different rules. IDA overwhelmingly cites violations of By-law 29.1 in its enforcement actions, along with considerable citations to its suitability regulations (By-law 1300), yet asserts specific other violations sparingly.

The following table summarizes NASD's enforcement actions during the Study Period.[168] The data are self-selected by the NASD through its Office of General Counsel which publishes the quarterly digests "to provide registered representatives with a summary sampling of recent disciplinary actions involving misconduct by registered representatives."[169] It chooses these samples "to call attention to, and remind registered representatives of, specific conduct that violates NASD rules and will result in enforcement."

Summary of NASD Self-Sample Enforcement Actions, June 2004 through December 2005

Total Cases = 49		
Cited Rule or Principle	Instances	% of Cases
2110 (Commercial Honour)	45	92%
Falsification of Documents/Forgery	9	18
Other Frauds	7	14
2310 (Suitability)	7	14
Disclosure in Form U4	6	12
Customer Accounts	5	10
3030 (Outside Business Activities)	4	8
3040 (Private Securities Transactions)	4	8
IM 1000-1 (Filing Misleading Information)	2	4
Other (one time only)	12	25

Just about every violation of an NASD Rule could conceivably be a violation of the bedrock principles stated in Rule 2110—requiring "high standards of commercial honour and just and equitable principles of trade." In fact, NASD seems to treat its enforcement theory in exactly this way. It invariably cites

[168] For NASD enforcement, data are derived from the NASD's Quarterly Disciplinary Reports from quarterly issues beginning with the Summer Issue of 2004 through the Winter Issue of 2005. For IDA enforcement, data are derived from the same documents from which the CSA enforcement data are derived (the CSA's 3 half-years beginning with April 1, 2004 and ending September 30, 2005, reported in each of its half-year Reports on Enforcement Activities). The overlapping periods are thus probably roughly co-extensive with each other and with the period of comparison for SEC-CSA enforcement.

[169] Such language appears as the preamble to essentially all NASD Quarterly Digests.

violation of Rule 2110 in nearly all highlighted cases, while in some half the cases also citing another specific Rule violation.[170]

The following table summarizes IDA's enforcement actions during the Study Period. The data are obtained by reviewing all specific enforcement actions from the period across all three CSA reports, and removing those concerning reports of adjustments or lacking associated bulletins citing the relevant violations. The result was a total of 88 enforcement actions identified during the 18-month period. The specific enforcement actions are virtually always accompanied by a Bulletin stating the specific violations of the Rule Book (or, in a small number of cases, other securities laws).[171]

Summary of IDA Enforcement Actions Noted in CSA Reports, April 2004 through September 2005[172]

Total Cases = 88		
Cited Rule or Principle	Instances	% of Cases
BL 29.1 (Conduct Unbecoming/Public Interest)[173]	64	72.7%
Reg. 1300 (Suitability)	32	36.3
Policy 2 (Supervision)	9	10.2
BL 19.5 (Cooperation with IDA)	6	6.8
BL 17.1 (Books and Records)	5	5.7
BL 17.2A (Internal Controls)	3	3.4
Other (one time only)	13	14.8

Of the 88 highlighted IDA actions, By-law 29.1 was the sole violation in 35 cases and appeared in another 29 cases, for a total appearance of 64/88 (72.7%). The next most common asserted violation was of Regulation 1300, which requires adequate supervision of accounts (including business conduct and suitability requirements). Violations of this Regulation appeared in 32 of the 88 cases (36.3%) (in all but one case, other violations accompanied this, 17 times with By-law 29.1).

The foregoing review (detailed in Appendix 2) indicates that the only IDA standards other than By-law 29.1 that are implicated more than once during the Study Period were Policy 2 concerning account

[170] Rule 2110 on commercial honour is cited alone in 24 instances and with other Rules in 21 instances.
[171] Summaries and analysis appear in Appendix B.
[172] The first CSA semi-annual report did not separately summarize IDA actions. The IDA summaries presented in the CSA Report do not usually cite rules by section or number or other designation. Instead they use descriptive characterizations of the enforcement action. The vast majority of these cite violations of By-law 29.1.
[173] IDA By-Law 29.1 on conduct unbecoming/public interest is cited as the sole source of violation in 35 instances and along other sources in 29 instances.

supervision (9 cases), By-law 19.5 (dealing with cooperating and providing information in enforcement actions) (6 times; once with 29.1 and 5 times alone); By-law 17.1 on books and records (5 times); and By-law 17.2A on internal controls (3 times). Thirteen other violations appeared, in each case only one time. These involve Regulation 200.1, Policy 3 (dealing with maintaining records and controls, respectively) and the following By-laws: 3.3, 4.7, 16.10, 17, 17.2, 18.11, 18.14, 20.42(1), 20.43, 29.27, 30.3, 30.5 and 38.[174] No other provisions of the Rule Book were identified in the Bulletins as resulting in enforcement of violations.

Several possible explanations appear for the strong principles-based enforcement bias that NASD and IDA both exhibit - and how they thus differ from the SEC and CSA. First, perhaps this is due to the essentially professional character of the enforcers. Securities trade associations are keen on public images of commercial honour and becoming conduct in the public interest. Apart from intrinsic value and related instrumental payoffs in deal flow and esteem, this helps to retain autonomy from legislative, administrative or judicial encroachment on professionalism. This makes it appealing to invoke broad, vague, professional sounding vocabulary.

Second, perhaps the rule-production function establishes and instantiates norms whose articulation reduces departure risks and consequences. If so, this means caution against jettisoning existing rules in the name of promoting a principles-based system of securities regulation. If rule-making and adoption help to instantiate the norms and promote ease of compliance, one would expect fewer departures relative to principles which are not well delineated. One would expect more enforcement action around principles. Then, with a critical mass of principles violations and enforcement, temptation would rise to articulate them as rules to achieve requisite clarity.[175]

This theory fits the pattern of NASD/IDA regulation and enforcement—and differs from the SEC/CSA pattern. NASD and IDA manifest exponential increases in rules on the books yet run enforcement distributions biased towards principles. The difference between the NASD/IDA pattern and the SEC/CSA pattern may be a partial product of the professional versus public enforcer attributes just noted. Related to this is the much narrower scope of enforcement jurisdiction of the professional enforcers compared to public enforcers. The nature of rule instantiation and creation may be stronger within the professional enforcement context compared to the broader, more diverse range of participants against whom public enforcement may be pursued.

[174] These address various matters noted in Appendix B's discussion.
[175] *See supra* text following note 40.

Putting the potential implications a different way, what would be lost if the rules were discarded? If rules do instantiate norms, then their promulgation and publication affect behaviour (although this behaviour is hidden from the enforcement manifest). New entrants into the profession receive and review copies of these materials—the rulebooks—constituting a formal expression of its expectations. Thus from a compliance perspective, scrapping the rules could communicate incorrectly that the rules no longer reflect accepted norms of practice. While this thesis seems supported by the NASD/IDA data, there also is an intuitive case for reaching the same conclusions as to rules applicable to the broader range of securities market participants subject to public enforcement.[176]

Results

Measuring effectiveness of professional enforcement of securities laws appears to be even more difficult than with public enforcement. At best, only indirect proxies are available to assess professional enforcement and neither NASD nor IDA provides much data or analysis. Given the overwhelming emphasis on principles-like violations, moreover, there is little basis to inquire into the relative enforcement effectiveness of principles-like activity versus rules-like activity. That said, some modestly interesting points may be noted.

First, consider the following NASD statistics. They speak both to enforcement activity and enforcement effectiveness.

NASD

Regulatory Actions	**2005**	**2004**	**2003**
Investor Complaints Received	5,137	4,687	4,843
New Disciplinary Actions Filed	1,399	1,396	1,410
Formal Actions Resolved	1,344	1,336	1,324
Firms Expelled	15	22	30
Firms Suspended	3	4	7
Individuals Barred	383	454	494
Individuals Suspended	357	379	333
Ads/Communications Reviewed	89,653	88,301	85,736

[176] *See supra* text accompanying notes 39-42.

Consider the number of bars and suspensions, as a possible measure of effectiveness. What to make of the figures is uncertain. NASD boasts some 700,000 registered representatives and some 5,100 firms. The relatively few numbers of individuals suspended or barred and firms suspended or expelled is striking (fewer than 400 individuals suspended and 400 barred annually and a total of 80 firms suspended or expelled in the full three-year period). While this could be the product of previous enforcement success and manifest vigilance, few would describe it as a sweeping enforcement program. In any event, however, these data do not provide a basis for evaluating relative enforcement effectiveness based on rules versus principles-like actions.

Following are selected IDA statistics.[177] They summarize the number and type of reports.

IDA

Type	**2005**	**2004**
Civil Claim	383	505
Criminal Charge	6	9
Customer Complaint	1,320	1,297
Denial of Registration/Approval	1	2
External Disciplinary Action	22	20
Internal Disciplinary Action	38	44
Internal Investigation	71	46
Total	**1,841**	**1,923**

These self-reported figures reflect even less than the comparable NASD figures about IDA's conception of its enforcement effectiveness. No detail is provided about the consequences of claims, charges or actions—either in terms of broad outcomes or specific fines, suspensions/bars or other remedial measures (such as installation of new internal controls or temporary compliance monitors).

Second, the level and distribution of fines is worth considering. NASD fines for violations of Rule 2110 alone (the commercial honour principle) range from U.S.$5,000 to U.S.$40,000 and include suspensions ranging from 10 days to 6 months—but most of the fines congregate towards the low dollar end of the

[177] These are captured and reported by IDA using its ComSet (Complaints and Settlement Reporting System). IDA explains its ComSet program as follows:

> With ComSet, staff can identify new and emerging compliance or regulatory issues, as well as patterns and trends in the industry, at the national, regional and firm level. It helps IDA staff focus on potential problems, areas that require enhanced compliance review, or events that warrant enforcement action. ComSet enables the IDA to be proactive in its oversight role, allowing for the efficient and timely allocation of resources and staff.

range and the suspensions of shorter direction.[178] NASD fines tend to be slightly higher in cases that cite violations in addition to or other than Rule 2110 (*i.e.*, more rule-like violations). They range from U.S.$5,000 to U.S.$130,000 and include suspensions ranging from 15 days to 18 months - and many of the fines are well in excess of U.S.$5,000 and include numerous fines exceeding U.S.$40,000.[179] For NASD, therefore, a slightly greater level of fines and suspensions appear in cases involving more rule-like violations than in those involving mainly principles-type violations.

In contrast, for IDA, of the 88 listed actions, the 35 involving By-law 29.1 alone imposed aggregate fines of CAN$1,936,000 or an average of CAN$56,000 apiece. At the other extreme, the actions involving rules alone (a total of 5 cases) yielded a total of CAN$195,000 or CAN$39,000 apiece on average.

This difference is hard to explain - it may simply be a coincidence and small sample size for IDA's rules-based violations. It could be a product of differing enforcement dynamics in the two countries or two professional organizations. Setting those likely explanations aside, relatively larger fines and suspensions in principles-only violations compared to other cases may help to explain a bias in enforcement activity towards principles rather than rules. This also could explain why the NASD's principles-based actions are often accompanied by invocations of rules as well.

Indeed, there is an intuitive case for imposing stiffer sanctions in the former case. Rebuke for unbecoming conduct or conduct detrimental to the public interest likely registers more severely with all concerned than failure to adhere to specific provisions of various by-laws. Perhaps the differences do reflect—and project - the common view that U.S. securities law is more rules-based: in the U.S. securities industry, violations of specific rules are more serious than of more abstract principles, such as commercial honour.

---

[178] Forgery-related activity in violation of Rule 2110 resulted in fines ranging from U.S.$5,000 to U.S.$15,000 plus suspensions of 10, 45, 60 or 90 days as well as permanent bars in three cases. Sanctions for disclosure violations under Rule 2110 included fines of U.S.$5,000 plus suspensions running from 30 days to one year and two permanent bars. Sanctions for catchall violations of Rule 2110 ranged from suspensions of 15, 30, 60 and 180 days plus fines of U.S.$5,000 and a permanent bar in one case. Sanctions in the market-timing case that violated Rule 2110 were a U.S.$40,000 fine and a 6-month suspension. *See* Appendix B.

[179] Penalties in NASD's highlighted unsuitability cases included fines of U.S.$5,000, U.S.$10,000 and U.S.$33,500; suspensions of 15 days, 30 days, 6 months and 18 months; restitution/disgorgement of up to U.S.$80,000; U.S.$60,000 combining fine and disgorgement; plus two permanent bars. Sanctions in cases involving customer funds and accounts were fines of U.S.$5,000 plus suspensions of 15, 20 and 30 days and two permanent bars. Sanctions in outside business activity cases included fines ranging from U.S.$5,000 to U.S.$7,500 plus suspensions of 10, 30, 90 or 180 days and for private securities transactions activity included fines of U.S.$5,000, U.S.$10,000 and U.S.$62,000, disgorgement, suspensions of 6, 12 and 18 months, and one permanent bar. Sanctions in NASD's research report cases were a U.S.$5,000 fine in one case and a U.S.$130,000 fine in the other coupled with a full suspension of 6 months and a research analyst suspension of 18 months. *See* Appendix B.

This possibility is reinforced by noting that when NASD enforces actions in the name of commercial honour, it often imposes below-average penalties; but when IDA enforces actions in the name of the public interest, it often imposes above-average penalties. Again, this may reflect belief, despite the study's analysis and conclusions, that the U.S. system is more rule-bound than principles-based. In addition to leading enforcers to believe that violations of rules are more serious than violations of abstract principle, it may also reflect a view that rule-enforcement is fairer because of the explicit notice associated with rules compared to principles. In contrast, to the extent of a willingness to embrace a more nationalistic conception of the public interest, violations of comparable concepts in Canada may provoke revulsion warranting more severe sanction.

Moving beyond these data, a final point about enforcement effectiveness bears noting. As between the NASD/IDA compared to the SEC/CSA, the respective regulatory audiences differ. The regulatory audience for SEC-CSA enforcement is primarily the investing public, writ large. The audience for NASD-IDA may include the investing public but this constituency is more nearly tertiary than primary or secondary. The professional enforcer's primary audience is its primary regulators—the SEC and CSA members—and its secondary audience is its own securities professionals members. The ultimate measure of enforcement effectiveness for NASD and IDA may be continued recognition by their respective superiors as the legitimate authority to regulate their own industry. This could help to explain the heavy NASD/IDA bias towards enforcing broad abstract principles.

iii. Private

Private enforcement of securities laws in the United States is a critical feature of the regime's overall effectiveness; it appears to play varying roles in Canadian provinces and efforts are ongoing as to this branch of the Canadian securities law framework. What bearing does this component of enforcement have on the distribution of securities laws along the principles-rules continuum and related enforcement activity and effectiveness? These are extraordinarily complex questions. A complete analysis would require a research study at least equivalent in scope to that provided concerning public and professional enforcement.[180] To explain this without conducting such a study, several important observations can be made.

[180] *Cf.* Puri, *Enforcement Effectiveness in the Canadian Capital Markets*, supra note 1 at 7 (noting that it is beyond the paper's scope to detail private enforcement "but it is an extremely important aspect of compliance and enforcement").

First, private and regulatory enforcement engines play fundamentally different roles in the initial exercise of law production. In addition to enforcement, regulators fashion law ex ante and consciously choose the tenor of those laws, including as to whether they bear attributes of principles or of rules. Private lawyers participate actively and directly in enforcement but face far more limited ability to fashion laws ex ante. True, they may participate in lobbying and in public comment processes during promulgation, but these capabilities are far more limited than those regulators command.[181] This limits a researcher's ability to evaluate the relative desirability of rules versus principles for private actors compared to regulators.

Second, even to the extent that private actors influence law production, private actors who participate face differing constituencies. For example, lawyers routinely retained to represent plaintiffs in securities law cases may hold contrasting views compared to those routinely retained to represent defendants. Neither may be certain, on any given question, of whether a law being drafted would be better for them or their clients if exhibiting more rules- versus principles-like qualities.[182] In general, rules provide certainty and so may appeal to probable defendants, but they also may be so prescriptive that compliance risk is significant. Principles allow for the exercise of judgment which probable defendants may find desirable but also may impair desired confidence that one's duties are fulfilled.

Third, in private civil litigation, lawyers are required and recognized to be performing an advocacy role. While public enforcement lawyers likewise play such a role, the stakes differ. The private lawyer acts uniquely on behalf of the current client; the public lawyer, as a governmental representative, operates with a view that goes beyond a present case. Public and private lawyers also likely see their objectives in a given case differently. For example, public lawyers may concentrate on advancing goals of deterrence and systemic features of efficiency and fairness. Private lawyers more likely focus on the goal of gaining compensation for current clients - and portions of contingent fees for themselves.

Fourth, public enforcement effectiveness can either be augmented or impaired by private enforcement.[183] Private parties likely care less about the consequences of their actions on an enforcement agency's own program. They may be willing to pursue theories and establish resulting laws that can disadvantage public

---

[181] *Compare* Bratton, *Rules Versus Principles Versus Rents*, *supra* note 34, at 1037-38 ("the government, although heavily populated with lawyers, at least operates at arm's length from the legal profession" in sharp contrast to the accounting profession, which writes its own rules).
[182] *Id*. at 1039 ("For every lawyer who closes ranks with a corporate client, there is another lawyer looking to bring suit against that first lawyer's client or, alternatively, to get the legislature to authorize a lawsuit. When the corporation's lawyer goes to Capitol Hill to get the client protective legislation, the trial lawyers also are there, working the other side.").
[183] Pitt & Shapiro, *supra* note 45, at 183.

enforcement agencies in later proceedings.[184] This may influence the relative distribution of cases as between rules and principles that public enforcers subsequently pursue - and also may influence the regulatory bias towards one of the spectrum or the other.

This raises, in turn, the question of overall enforcement effectiveness. This is a hotly contested issue. One school of thought (sometimes dubbed a law-and-economics viewpoint) extols the virtues of private enforcement while socio-legal viewpoints celebrate more fully the virtues of public enforcement.[185] This debate implicates underlying disagreement as to the purpose of securities laws - whether geared toward compensation or deterrence, for example - and thus how to evaluate whether they and related enforcement are effective. The significance of that disagreement amplifies when considering the role that rules versus principles play in related enforcement activity and effectiveness. Whatever preferences regulatory enforcement authorities may have in that dimension can be upset by overlapping private enforcement.

Closely connected to the foregoing debate is yet another hotly contested issue in private securities law enforcement discussions: whether and to what extent the merits matter in private securities law enforcement. Private lawyers can prosecute meritorious or frivolous claims, the latter to exact so-called nuisance settlements. Researchers have reached different conclusions as to the relative distribution of such cases and also reach different conclusions about how various legal reforms influence that distribution.

Fifth, for private enforcement, the distinction between procedural and substantive law is more important than in public enforcement. Procedural law includes pleading, standing, discovery and the law of evidence (including burdens of pleading, persuasion and proof). Substantive law includes bases for liability and measures of damages. As with the rules-principles classification, these reside on a continuum and can combine attributes both. For example, of mixed order are laws regulating the allocation of damages, such as laws specifying joint and several liability versus proportionate liability,[186] the doctrine of loss causation and related pleading requirements necessary to aver such an element of a claim.

For private securities litigation, laws and reforms that implicate matters of procedure have little to contribute to a discussion of rules versus principles. Instead, the issue is the ease or difficulty of

---

[184] *Id*. at 183.
[185] *See* Condon, *Enforcement and Litigation in Ontario Securities Regulation*, *supra* note 31 (citing and discussing Raphael La Porta, Florencio Lopez-de-Silane & Andrei Shleifer, *What Works in Securities Law?*, (2003)); CONDON, ANAND & SARRA, *supra* note 37 at 545 (similar).
[186] *E.g*., Private Securities Litigation Reform Act of 1995.

navigation for plaintiffs or facility of resisting or dismissing claims for defendants. Thus pleading laws that require plaintiffs to give more than mere notice of a claim - but to specify in reasonable detail the nature of the alleged wrongs - are loathed by plaintiffs but embraced by defendants. Such pleading constraints can frustrate plaintiffs' right to pursue discovery, another reason they are favoured by defendants and hated by plaintiffs. Proportionate rather than joint liability allocation rules typically are better for defendants and worse for plaintiffs.

Sixth, securities law enforcement agencies have jurisdiction over securities laws, but not necessarily other bodies of law that may be implicated by a given set of circumstances or kind of conduct. For example, in the U.S., states have primary authority for regulating the internal affairs of corporations. States define these laws and private actors may enforce them. They may do so by bringing claims arising under both federal securities law and state corporate law. The SEC lacks power either to define or enforce such corporate laws. This difference makes analyzing the role that rules versus principles play in securities law enforcement more complex for private actors compared to public and professional actors.

In summary, full investigation of the influence of rules versus principles on private securities law enforcement and effectiveness - and of how such enforcement influences their relative distribution in the population of such laws - is exceedingly complex. The foregoing offers some reflections upon why this is so. But, as noted, a full-scale evaluation of these issues would require a study at least as involved as the current study's inquiry into public and professional enforcement.

5. Conclusion

Rules and principles are both necessary and desirable features of an overall securities regulation system. Whether laws are better cast in one form or the other depends on trade-offs involving certainty versus contextual judgment on the one hand and relative novelty versus norm recognition on the other. Aspirations to create securities regulation regimes denominated as principles-based or rules-based likely are conceptual fantasies, given the nature, complexity and capaciousness of these labels.

Evaluating enforcement effectiveness requires stating ultimate goals of underlying laws (whether rules, principles, factors). These principally are advancing both efficiency and fairness (which, in turn, are instruments to promote goals of investor confidence and investor protection). A comprehensive enforcement policy promotes those goals so long as underlying laws exist to facilitate them. This should

be manifest in various analytical proxies, including a propensity of respondents to settle enforcement actions.

These realities imply a need for a comprehensive enforcement program that does not over-emphasize enforcement of either rules or principles but pursues both in rough proportion to their presence in the overall population of laws. It appears desirable for enforcers to state that such a comprehensive program is both a goal of the program and a measure of enforcement effectiveness.

An enforcement policy should be supplemented, from time to time, by focused enforcement activity trained on publicly visible crises. These may erupt as a result of insufficiently specified underlying laws that require enforcement activity bearing a more principles-like character, although some public debacles also involve bald violation of clear rules. Either way, enforcement activities that consciously respond to public outcries are intended to promote all securities regulation's goals, of efficiency and fairness and of confidence and protection. They do so by highlighting and then exterminating behaviour deemed undesirable based upon the public rebuke that provokes stepped-up enforcement.[187]

[187] In the contemporary contexts of mutual funds and research analyst scandals, the U.S. states attorneys general played a supporting or catalyzing role, suggesting how they can be more in tune with such bubbling public sentiments. *See* Renee M. Jones, *Dynamic Federalism: Competition, Cooperation and Securities Enforcement*, 11 CONN. INS. L. J. 107 (2004). Inferences for Canadian national or provincial enforcement are outside this study's scope.

Lawrence A. Cunningham
Professor of Law & Business and Associate Dean for Academic Affairs
Boston College Law School
885 Centre Street
Newton, MA 02459

Lawrence.Cunningham@bc.edu