Osgoode Hall Law Journal

Volume 19, Number 3 (September 1981)

Article 3

Administrative Enforcement Powers and Procedures under the Proposed Securities Market Law

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ADMINISTRATIVE ENFORCEMENT POWERS AND PROCEDURES UNDER THE PROPOSED SECURITIES MARKET LAW

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The purpose of this article is to examine briefly those key provisions of the proposed *Securities Market Law for Canada*[1] *(Draft Act)* that create discretionary administrative enforcement powers to investigate, prosecute, adjudicate, and impose administrative sanctions. Few powers of government are more worthy of attention, as powers of enforcement are usually, either explicitly or implicitly, discretionary powers. Reasonable grants of discretion are practical necessities for the sensible enforcement of the law. At the same time, uncontrolled discretion carries the seeds of arbitrariness. Achieving a proper balance is not always easy.

This analysis of Parts Fourteen and Fifteen of the *Draft Act* identifies the basic enforcement powers delegated to the Canadian Securities Commission (CSC)[2] and examines the extent to which the Act attempts to confine, control, and structure the manner in which enforcement discretion is exercised. In particular, the analysis concentrates on three important aspects of administrative law enforcement: (1) the investigatory power, with particular emphasis on: the subpoena power, the search and seizure power, and the power of adverse publicity; (2) the hearing, or adjudicatory, power, including initial agency decisions; and (3) the administrative sanctioning power, including the opportunity to negotiate administrative settlements of enforcement actions. In connection with the analysis of the sanctioning powers, some suggestions are offered that might provide the CSC with a principled basis for selecting appropriate sanctions.

I. INVESTIGATIONS

Section 14.01(1) of the *Draft Act* empowers the Commission to authorize its staff to conduct an investigation. The section's important feature lies in the CSC's investigatory discretion. It is not limited to cases evincing a probable cause to believe that the law has been violated; rather, the CSC need merely intend "to ascertain whether any person has violated, is violating, or is about to violate a provision of this Act. . . ."[3] In all likelihood, the

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[1] Anisman *et al.*, 1 *Proposals for a Securities Market Law for Canada* (Ottawa: Minister of Supply and Services, 1979).

[2] The *Draft Act* creates "a commission to be known as the Canadian Securities Commission." *Id.*, s. 15.01(1).

[3] *Id.*, s. 14.01(1). The same broad powers of investigation have long been recognized in the United States. See, *e.g.*, *Oklahoma Press Publishing Co.* v. *Walling*, 327 U.S. 186, 66 S. Ct. 494 (1946).

CSC will ordinarily limit the use of its investigatory powers to those cases in which there is at least a suspicion of wrongdoing or a public complaint alleging that the law has been violated.

If the CSC decides to authorize a formal investigation, at least three important investigatory powers will be available: (1) the subpoena power, (2) the search and seizure power, and (3) the power to publicize results of investigations. Each power is necessary if the purposes of the Act are to be achieved, but, if unchecked, each discretionary power of investigation provides the potential for unreasonable and unnecessary governmental intrusion into private and corporate affairs.

A. *Subpoenas*

A person authorized to conduct an investigation pursuant to section 14.01(1) has the discretion to issue subpoenas to compel either testimony or the production of books of records.[4] The use of the subpoena power does not require a demonstration of probable cause. Rather, the testimony or books and records requested need only be "relat[ed] to the subject of an investigation."[5] It is no defence to a subpoena to assert that either the testimony or the books or records demanded may tend to incriminate the party.[6] Although section 14.01(10) prevents the use of such evidence in a subsequent proceeding, it is not an immunity provision. It does not prohibit the CSC from instituting an enforcement action against a party who has been compelled to give incriminating evidence. Rather, it prohibits the CSC or other governmental authority from using such evidence against the person in a subsequent enforcement proceeding.

A person who is subpoenaed is entitled to be represented by counsel.[7] Representation by counsel, however, does not include the right to have counsel present at all investigatory hearings, nor does it include the right to cross-examine witnesses testifying before the staff of the CSC in an investigatory hearing.[8] Such cross-examination becomes available only in subsequent formal enforcement actions, including administrative adjudications, civil trials and criminal prosecutions.[9] The Act, however, specifically maintains solicitor-client privilege.[10]

If a party refuses to comply with a subpoena, the Act provides two enforcement options. First, section 14.06(1) authorizes the CSC to obtain a court-issued order compelling the subpoenaed party to comply or be cited for contempt of court. The second enforcement alternative is criminal prose-

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[4] *Supra* note 1, s. 14.01(2).

[5] *Id.*

[6] *Id.*, s. 14.01(10).

[7] *Id.*, s. 14.01(9).

[8] Anisman *et al.*, 2 *Proposals for a Securities Market Law for Canada* (Ottawa: Minister of Supply and Services, 1979).

[9] See text accompanying notes 28-51, *infra.*

[10] *Supra* note 1, s. 14.01(6).

cution pursuant to section 14.10(3), which specifically subjects a "person who fails without reasonable excuse to obey . . . a subpoena" to a $2,500 fine or imprisonment for six months or both. Moreover, section 14.10(1) (b) subjects a party who "knowingly or recklessly makes a misrepresentation . . . in connection with an investigation" to a fine of $25,000 or imprisonment for ten years or both.

B. *Searches*

The second important investigatory power of the CSC is the power to search premises and to seize documents that are related to the investigation.[11] Two kinds of searches are authorized by the *Draft Act*. Section 14.03 authorizes a warrantless search ("examination") of the premises of licensed broker-dealers and section 14.01(4) provides for a court-authorized search of other premises.

Although a section 14.01(4) search must be authorized by a court, the statutory requirements do not include proof of probable cause as traditionally understood in the criminal context.[12] Rather, the CSC need only demonstrate that it has "reason to believe that evidence relating to the subject of the investigation may be found" on the premises.[13] This is in keeping with the requirements for investigation authorization.[14]

A section 14.01(4) search requires court authorization; a section 14.03 search does not. This dichotomy parallels the development of the law of administrative searches in the United States, highlighted by the recent decision in *Marshall* v. *Barlow's Inc.*[15] In *Barlow's* the United States Supreme Court stated that a warrant was required to search the premises of a federally regulated party, but it held that the warrant would issue without proof of traditional probable cause; the warrant would issue if the search was in connection with a legislatively authorized investigation and if it was being conducted at a reasonable time and in a reasonable manner.[16] This rule is embodied in subsection 14.01(4) of the *Draft Act*. Moreover, the *Barlow's* decision also recognized, as does section 14.03, that under some circumstances no warrant at all is required where the legislature has authorized inspections of "pervasively regulated businesses" or businesses "long subject to close regulation."[17] Thus, under American law, a warrantless search of broker-dealers pursuant to section 14.03 would probably fit within the *Barlow's* exception for a "pervasively regulated business" (that is, the brokerage business), whereas a section 14.01(4) search would apparently satisfy

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[11] *Id.*, ss. 14.01(4), 14.03.

[12] *I.e.*, reason to believe that the law has been violated.

[13] *Supra* note 1, s. 14.01(4).

[14] See text accompanying note 3, *supra*.

[15] 436 U.S. 307, 98 S. Ct. 1816 (1978).

[16] *Id.* at 320 (U.S.), 1824 (S. Ct.) [citations omitted.]

[17] *Id.* at 313 (U.S.), 1820 (S. Ct.) [citations omitted.]

the watered-down warrant requirement of *Barlow's*, which does not require reasonable belief that the law has been violated.

If the CSC attempts to gain entry to premises pursuant to section 14.01 (4) and to seize records that the owner does not believe are reasonably related to the investigation, an opportunity to contest the CSC power to seize such materials is provided by section 14.01(7). In such a case, the CSC is instructed to seal the records pending an independent court determination of their relevance to the investigation.[18]

If records are seized, section 14.01(8) requires the CSC to return the records within sixty days after they are taken and, in any event, to provide owners with an opportunity to examine or to make copies of the records at the CSC's expense.

Sections 14.01(5) and 14.03(3) direct compliance with CSC searches. Refusal to comply exposes the violator to the enforcement proceedings encompassed by sections 14.06(1) and 14.10(3), described above.

C. *Publicity*

A third discretionary power of the Commission is the power to publicize facts relating to an investigation prior to taking formal enforcement action. The power of publicity is not always fully appreciated. As a practical matter it is one of the most important enforcement powers of government, particularly when regulating a business sensitive to allegations of fraud, such as the securities business.[19] The mere publication of information that a person is under official investigation for fraud can have damaging, sometimes irreversibly damaging, consequences.

The *Draft Act* provides certain protections against unnecessary adverse publicity. First, section 14.01(11) provides that all investigations shall be non-public, thus prohibiting intentional leaks of the investigation to the press. Second, section 14.01(13) places restrictions on the CSC's issuance of reports concerning an investigation. In particular, the section permits only the CSC to issue reports, not the staff. In addition, the section imposes procedural limitations on the issuance of reports by the CSC. Section 14.01(13) (a) requires the CSC to provide subjects of an investigation an opportunity to be heard and to be represented by counsel before it publishes a report that includes an adverse finding against that party. It is important to note, however, that the section does not envision a right to cross-examination, but only an opportunity to respond to findings.[20]

Under some circumstances a person may be "likely to receive adverse publicity" as a result of a published report even though he is not the subject of a specific adverse finding. Such a person is to be given, "if practicable, . . .

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[18] *Supra* note 1, s. 14.01(7).

[19] See, *e.g.*, Gellhorn, *Adverse Publicity By Administrative Agencies*, 86 Harv. L. Rev. 1380 (1973).

[20] See, *supra* note 8, at 307.

a reasonable opportunity to prepare a response prior to publication."[21] This is not the equivalent of the opportunity to be heard provided by section 14.01(13) (a). Rather, it is an opportunity to prepare a public response to any press release that adversely affects the reputation or interest of the party.

The section 14.01(13) restrictions on publicity are important. They tend to protect the interests of the subjects of an investigation, as well as the interests of others who become involved in an investigation but are not its target. At the same time, the *Draft Act* recognizes the importance of permitting the CSC to carry out its responsibility to publicize its enforcement activities and thus warn the public of potential problems. If, as a result of an investigation, the CSC decides to institute a formal enforcement action, whether administrative, civil, or criminal, the adversely affected party will have the opportunity to engage in a full trial-type proceeding to protect its interests.[22]

The administrative power to penalize by adverse publicity is reasonably contained by the Act. But one must not underestimate the potential for abuses in the use of publicity,[23] particularly when used against a person who the Commission believes has violated the law, but against whom they are unable to assemble *prima facie* evidence of wrong-doing that would withstand judicial scrutiny. In such instances, adverse publicity is itself a sanction that can injure the business and reputation of a regulated party without providing that person with his day in court.

II. ADMINISTRATIVE HEARINGS

A. *Enforcement Options*

If an investigation reveals evidence of a violation, the CSC has several enforcement options. First, it may decide not to take formal action. For example, in some cases the CSC may be willing to forgo formal action if it is satisfied that a minor violation of the law has occurred but that investors have not been injured and the violator has adopted new procedures to prevent future infractions. Formal and informal settlements are discussed in more detail below.[24] Second, the Commission may be satisfied that the investors injured by the violation are pursuing private remedies under the Act that will adequately serve the overall enforcement objectives of the CSC.[25] Third, the CSC may be satisfied that the provincial securities commissioners are best able to handle the problem, thus avoiding duplicative enforcement efforts by the federal government.[26] Fourth, the CSC may be satisfied that

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[21] *Supra* note 1, s. 14.01(13)(b).

[22] See text accompanying notes 28-51, *infra.*

[23] "[T]he relief sought by the Commission, even if granted, may not be as significant or as onerous a sanction as the publicity attendant upon the commencement of the proceeding." SEC, *Report of the Advisory Committee on Enforcement Policies and Practices* (Washington D.C.: SEC, 1972) at 29.

[24] See text accompanying notes 70-79, *infra.*

[25] Private rights of action are provided in Part 13 of the *Draft Act.*

[26] The *Draft Act* requires co-operation with the provincial securities commissions, "in order to minimize duplication of effort. . . ." *Supra* note 1, s. 15.12.

the efforts of "self-regulatory organizations" are adequate to resolve the particular problem.[27] If, however, the CSC decides that it must take action, it has three formal enforcement options: civil, criminal and administrative. This section presents a brief overview of the formal enforcement options, followed by a description of the administrative hearing procedures mandated by the *Draft Act.*

1. Civil Remedies

There are three basic civil remedies available to the CSC, each of which is found in Part 14 of the *Draft Act.* Section 14.06 authorizes a "compliance order." To obtain a compliance order, the CSC may "apply to a court for an order requiring compliance with or restraining a violation of a provision of this Act, a regulation, a by-law or a Commission order." This is essentially a form of injunctive relief.[28] Second, section 14.07 authorizes the CSC to apply to a court for the appointment of a receiver under circumstances where such action is in the interest of the investing public. Such an action can be accomplished in an *ex parte* proceeding "for a period not exceeding 15 days," after which a full hearing must be provided.[29] Third, the CSC has the unique authority to institute a "derivative" action on behalf of either an issuer or a security holder of an issuer if the CSC believes that the law has been violated and either the issuer or the security holder has failed or is unable to commence an action on its own.[30] If the CSC elects to pursue any one of these civil remedies, it may request the court to grant ancillary relief including restitution, disgorgement of profits, or other permitted relief, if it is deemed necessary.[31]

2. Criminal Remedies

In addition to the civil remedies, the Commission may also initiate criminal prosecutions against violators. Section 14.10 describes three classes of criminal offences, with penalties ranging from a $25,000 fine and ten years imprisonment to a $2,500 fine and six months imprisonment. An important provision of the *Draft Act,* section 15.08, permits the CSC to prosecute its own criminal cases, rather than relying on provincial or federal prosecutors to try such cases.

3. Administrative Remedies

There are three administrative remedies, each of which requires the CSC to conduct a full hearing pursuant to section 15.17 of the Act.[32] The three remedies are: cease trading orders, freeze orders, and broker-dealer disciplinary proceedings. A person who violates an administrative order of the

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[27] Self-regulatory organizations are authorized by Part 9 of the *Draft Act.*

[28] See, *supra* note 8, at 317-19.

[29] *Supra* note 1.

[30] *Id.*, s. 14.08.

[31] *Id.*, s. 14.09.

[32] See text accompanying notes 35-51, *infra,* where s. 15.17 hearings are discussed.

Commission is subject to a fine of $5,000 or imprisonment for one year or both.[33]

Cease trading orders are authorized by section 14.04 and permit the CSC to order all trading in a particular security or by a particular individual to cease if the CSC believes that certain enumerated violations of the Act have occurred. Although a cease trading order ultimately requires a section 15.17 trial-type hearing, section 14.04(4) permits the CSC to summarily suspend trading for a period of fifteen days if the public interest requires it.

Section 14.05 authorizes the CSC to issue a freeze order, which is intended to protect the assets of investors in the hands of fiduciaries suspected of having violated the law. Again, while freeze orders must ultimately provide for a section 15.17 trial-type hearing, the CSC may summarily freeze assets for fifteen days if the public interest so requires.

Section 8.02 authorizes the CSC to "reprimand" a broker, or to "deny, suspend, cancel, or restrict" the broker's registration. Section 8.02(2) outlines certain violations of the Act that justify the imposition of an administrative sanction. It does not, however, provide guidance for the CSC in deciding which sanction should be imposed. This question is discussed in Part III of this article.[34]

In addition, section 8.02(6) authorizes the CSC to summarily suspend the registration of a broker-dealer, provided that a full section 15.17 hearing is held within fifteen days of the issuance of the suspension order.

B. *Administrative Hearing Procedures Under Section 15.17*

If the CSC decides to pursue one of the administrative remedies, it will be required to provide a section 15.17 trial-type hearing, which is similar to the hearing required by sections 554-556 of the *Administrative Procedure Act*.[35] The following are its key elements:

1. The CSC is required to give notice, including "a statement of the time, place and purpose of the hearing," the statutory authority under which the hearing will be held, a concise statement of the allegations of fact and law, and a statement that if the person fails to attend at the hearing, the Commission may proceed without giving him further notice.[36]

2. All parties to the proceeding are entitled to be represented by counsel and all witnesses are entitled to be "advised by counsel."[37]

3. Evidence may be admitted without regard to the technical rules of evidence if the adduced evidence is "relevant to the subject matter of the proceeding."[38] Evidence, of course, may be relevant without necessarily be-

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[33] *Supra* note 1, s. 14.10(2).

[34] See text accompanying notes 57-69, *infra*.

[35] 5 U.S.C. §§ 554-56 (1976).

[36] *Supra* note 1, s. 15.17(1).

[37] *Id.*, s. 15.17(4), (5).

[38] *Id.*, s. 15.17(6).

ing "substantial."[39] Presumably, the evidence ultimately relied on to support findings must also be "substantial," although section 15.17(6) does not specifically so require. The Act would be much improved by adding a provision that specifically required all findings of fact to be based on evidence that is substantial, that is, evidence that a reasonable mind might accept as adequate to support a conclusion, whether or not it comports with the technical rules of evidence. Interestingly, section 15.19, which provides for judicial review of CSC orders, does not specifically set forth a standard of review for questions of fact or the quality of the evidence that must support findings of fact.

4. The Commission is authorized to take judicial notice of "any generally recognized scientific or technical fact, information or opinion within its area of expertise."[40] This fact-finding short cut, sometimes referred to as "official notice,"[41] is common in administrative law. It should be noted, however, that under the *Administrative Procedure Act* in America a commission would be required to give the party against whom such evidence is used an opportunity to rebut.[42] Such a provision is not explicitly provided by section 15.17; a provision for oral or written rebuttal would improve the *Draft Act.*

5. Section 15.17(10) (a) authorizes the CSC to promulgate rules that could, among other things, eliminate the right to cross-examination. Although section 15.17(4) gives parties the right to cross-examine witnesses, this right is subject to modification by rule pursuant to section 15.17(10) (a). In general, it makes sense to eliminate cross-examination in those kinds of proceedings in which it would serve no purpose,[43] but the right should not be uncritically eliminated simply to streamline hearing procedures. Particularly where findings of fact need to be based on oral testimony about disputed facts, the right to cross-examine should be preserved.

6. Section 15.17(8) requires the CSC to state in writing its findings of fact and reasons. This provision not only facilitates review of initial agency decisions, but tends to ensure more careful decision-making.[44] The *Commentary* to the *Draft Act* states:

> [o]nly decisions involving questions of policy or principle, whether the adoption of new policy or a change in an existing policy, require substantial explanation. Routine decisions may be treated summarily and need contain only a statement of

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[39] *I.e.* such evidence as a reasonable mind might accept as adequate to support a conclusion. See Jaffe, *Judicial Control of Administrative Action* (Boston: Little, Brown, 1965) at 596; *Consolidated Edison Co.* v. *N.L.R.B.*, 305 U.S. 197 at 229, 59 S. Ct. 206 at 216-17 (1938). Professor Jaffe has made the following observation:

> I suggest that for *reasonable* mind we might substitute *reasoning* mind. The law demands evidence sufficient to enable a mind to find the legally required fact by reasoning from that evidence. The juror may be ever so reasonable as a man..., but the law requires... that he arrive at the verdict... *by reasoning from the evidence.* Jaffe, *op. cit.*, at 596 [emphasis added.]

[40] *Supra* note 1, s. 15.17(6).

[41] See generally 5 U.S.C. § 556(e) (1976).

[42] *Id.*

[43] See, *e.g.*, Cramton, *A Comment On Trial-Type Hearings In Nuclear Power Plant Siting*, 58 Va. L. Rev. 585 (1972).

[44] See Friendly, *Some Kind of Hearing*, 123 U. Pa. L. Rev. 1267 at 1292 (1975).

> the salient facts and a reference to a regulation or an earlier Commission decision.[45]

Whether one agrees with the *Commentary*'s analysis must depend upon how "routine decisions" are defined. Is the decision to suspend a broker-dealer's registration "routine?" For reasons discussed in Part III,[46] it is hoped that the reasons supporting the imposition of a broker-dealer sanction will do more than state "the salient facts" and refer "to a regulation or an earlier Commission decision." If a reasons requirement is to guard against arbitrary action, the reasons must adequately describe why a particular sanction is being selected, not simply state that the CSC has the bare statutory authority to select it.

7. Finally, section 15.17(3) provides that all hearings shall be "public unless the Commission provides otherwise, by rule or order, to protect the interests of the persons affected." The question whether an administrative hearing should be public or private has been hotly debated.[47] This provision places the burden on the CSC to decide the issue, but specifically requires the hearing to be public "if all persons directly affected and appearing so request."[48]

Although the Act requires the CSC to provide a hearing of the kind described above, it is not necessary that the CSC itself conduct the initial hearing. Section 15.09 permits the CSC to delegate the hearing responsibility to "a commissioner, an employee or administrative unit of the Commission." In the event that the hearing is held by persons other than the CSC, the Act permits the affected party to appeal a "final order" to the full CSC.[49] If the CSC delegates its hearing authority for the purpose of conducting a broker-dealer disciplinary proceeding, it must delegate its authority "to a person who has not participated in the investigative or prosecuting functions of the Commission and who is not responsible to or subject to the supervision or direction of a person who has so participated."[50] Obviously, this provision is intended to ensure separation of functions so that the prosecutor does not also judge. Finally, if the CSC delegates responsibility for the initial hearing to a commissioner, that person is disqualified from sitting on the appeal of the order.[51]

An adversely affected party that has exhausted its administrative remedies of review is entitled to judicial review,[52] except in the case of summary

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[45] *Supra* note 8, at 362-63.

[46] See text accompanying notes 57-69, *infra*.

[47] See, *e.g., Proceedings of the 1964 Midyear Meeting of the House of Delegates*, 89 Ann. Rep. of the A.B.A. 110 at 135 (1964).

[48] *Supra* note 1, s. 15.17(3). Note that the CSC may also delegate to those outside the CSC.

[49] *Id.*, s. 15.18.

[50] *Id.*, s. 15.09(2).

[51] *Id.*, s. 15.09(3).

[52] *Id.*, s. 15.19.

orders.[53] Summary orders, however, are ultimately subject to a full section 15.17 hearing and the order which results from that hearing may be reviewed under section 15.19.

Appeals from cease trading orders and freeze orders can be successful only if the petitioner is able to demonstrate to the reviewing court that the order is "arbitrary, capricious or an abuse of discretion."[54] Presumably, this implies that the scope of review for appeals from broker-dealer disciplinary proceedings is to be broader; how much broader is not clear.[55] One possibility is that broker-dealer review will subject the CSC's findings to the substantial evidence rule as a basis for review, whereas review of other orders under the "arbitrary, capricious or abuse of discretion" standard will not include a substantial evidence inquiry. Such a distinction, however, is not persuasive. If the factual basis for a cease trading order or freeze order is not supported by substantial evidence, that is, evidence that a reasonable mind would consider as adequate to support a conclusion, the order would seem to be unreasonable by definition. If it is unreasonable, presumably it is also arbitrary. The judicial review provisions of section 15.19 would be clarified, if not strengthened, by providing a more detailed statement of the scope of review for the various administrative orders in order to give both the courts and affected parties a clearer indication of the basis for review. It should be noted that the scope of review provisions for judicial review of agency regulations pursuant to section 15.20 are much more precise; section 15.20(5), in particular, lists five bases for judicial review, including judicial scrutiny of the adequacy of fact findings.[56] If the factual basis for an agency regulation is subject to scrutiny, the evidentiary basis for an order should also be subject to review.

III. ADMINISTRATIVE SANCTIONS

As noted, section 8.02(2) of the *Draft Act* grants the CSC discretion to reprimand, suspend, cancel, restrict or impose other conditions on the license of a broker-dealer. The question addressed here is how the CSC should decide which sanction to choose in a given case.

It is sometimes suggested that the imposition of a sanction is best left to the complete discretion of the agency on a case by case basis. At the other extreme, it is sometimes suggested that a mechanical formula will magically eliminate all problems associated with the choice of sanctions. Both positions are extreme and both risk inherent unfairness in the treatment of particular offenders. The former position implies that principled choice is not possible, and thus risks unfairness by tolerating either the consciously or the inadvertently inconsistent treatment of like cases. The latter position risks unfairness by being overly rigid, thus denying the agency the flexibility necessary to

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[53] *Id.*, s. 15.19(7).

[54] *Id.*, s. 15.19(6).

[55] See, *supra* note 8, at 370.

[56] *Supra* note 1, s. 15.20(5)(e).

meet the demands of individualized justice by selecting a sanction that fits the offence and the offender. The purpose of this section is to explore briefly the need to articulate standards that will guide the exercise of the CSC's discretion when selecting a sanction for a particular case. Standards are necessary that will enable the CSC to achieve reasonable consistency between like cases without unnecessarily infringing upon the CSC's reasonable expectation of flexibility to meet the particular problems of individual cases. In short, there is a need to formulate a framework to provide a principled basis for decisions. A related problem is also explored, namely, the procedure by which a regulated person suspected of having violated the law may enter into a settlement with the CSC and thus avoid the time, the expense and the possible adverse consequences of publicity which would result from a section 15.17 adjudication. The imposition of a sanction after a formal section 15.17 hearing and the imposition of a sanction as part of a negotiated settlement present similar problems for the even-handed enforcement of law.

A. *Factors That Influence Sanctioning Decisions*

In an earlier study, the author attempted to isolate those factors that appear to influence the selection of sanctions by the Securities Exchange Commission (SEC).[57] In particular, an attempt was made to isolate factors that described both the offence and the offender in an effort to determine their correlation, if any, to the sanction ultimately selected. Thus, for example, factors describing the individual offender include, but are not necessarily limited to, age, experience, prior record, general reputation, current status in the industry, evidence of intent to commit the violation, willingness to reform, willingness to make restitution, and willingness to consent to the imposition of the sanction. Factors that describe the offence include not only the particular statutory section or rule involved (from which one can make certain determinations regarding the severity of the offence involved) but also the geographic scope of the violation, the amount of money involved and the number of investors involved.

By analyzing over three hundred cases in which the SEC described the factors that influenced its decision, it was possible to determine the degree of correlation between certain factors describing both the offender and offence and the ultimate sanction imposed. For example, although 37.8 percent of all cases resulted in expulsion ("cancellation" under the *Draft Act*), the expulsion rate tended to increase if the offence involved fraud (42.1%), or an intentional violation of the law (53.2%), or if the respondent had a prior record (66.7%), or contested the SEC's action (62.1%). On the other hand, the expulsion rate tended to decrease in those cases which did not involve fraud (21.1%), or if the respondent offered to make restitution (20%), or had a good reputation (17.8%), or consented to the imposition of the sanction (25.5%), or was willing to reform (3.7%).[58]

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[57] Thomforde, *Patterns of Disparity in SEC Administrative Sanctioning Practice*, 42 Tenn. L. Rev. 465 (1975).

[58] *Id.* at 493.

Obviously, the above figures are very general and the cases were subjected to further detailed analysis and comparison in the actual study. But it is fair to summarize the results of the study by saying that certain factors do tend to correlate with the severity of the sanction imposed. Not surprisingly, however, it was also found that some factors were not always noted by the SEC in particular cases, even though they were discoverable and their relevance acknowledged by the SEC in other cases. Finally, the study revealed a substantial disparity of sanction severity in some cases, despite the fact that apparently similar factors were present. In short, while the study revealed a strong and predictable correlation between certain factors and the severity of the sanction imposed, it indicated that the SEC was not always as consistent as possible in noting or applying those factors in some cases. This is not to suggest bad faith on the SEC's part—quite the contrary. The problem of selecting reasonably similar sanctions for reasonably similar cases is a most difficult one for the conscientious decision-maker.

The importance of the sanctioning decision and the care with which a commission attempts even-handedly to impose sanctions is important not only to the offender but also to the public at large.

The fact that a study of the SEC's sanctioning practice reveals a high correlation between certain factors and sanction severity does not end the inquiry, however. Are the sanctions that are usually selected in given classes of cases appropriate? How does one test the necessity, desirability, or validity of a sanction?

B. *Guidelines for Sanction Selection*

The problem of inconsistency requires the articulation of a set of principles or standards that might guide the decision-maker in selecting an appropriate sanction.[59] Such standards might be found in the statute itself. They might also evolve in a common law fashion based on the CSC's experience, or they might be derived from the experience of similar agencies in both Canada and the United States. Once discovered and approved, they might ultimately be embodied in a statute, a formal rule, or in informal guidelines. The form that the standards take is not important; what is important is that the CSC attempt seriously to formulate standards that will provide a framework for principled decision-making.

The *Draft Act* itself provides only a partial answer. Section 8.02(2), which grants the CSC the authority to select from among reprimand, suspension, or cancellation, contains only one standard: the CSC must find that one of the several specific violations has taken place before a sanction can be imposed.[60] Assuming, however, that the CSC finds that a violation has occurred, the statute does not inform the CSC whether it should merely reprimand the broker or, at the other extreme, cancel the registration.

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[59] See Thomforde, *Controlling Administrative Sanctions*, 74 Mich. L. Rev. 709 (1976).

[60] *Supra* note 1, s. 8.02(2).

Some American courts have suggested that the validity of an administrative sanction can be tested, at least in part, by identifying the purpose of the sanction.[61] If the administrative sanction is primarily remedial, rather than punitive, the choice of sanction in a particular case may be affected. Admittedly the remedial-punitive distinction is vague and can lead to what Justice Frankfurter once described as "dialectical subtleties."[62] But the distinction does help to focus the inquiry. If the primary purpose is to punish the offender, the question whether the person is a danger to investors generally, or whether investors have been injured by the violation, becomes less relevant. On the other hand, if the purpose is primarily to protect investors and to insure compliance with the law (the remedial purpose) a different result might follow. For example, although a given person has knowingly violated the law, it is possible that no investor was injured (because restitution was made) and that the person does not pose a future danger to the public (because he has voluntarily withdrawn from the securities business). Those factors might result in a less severe sanction if the primary purpose is to protect investors, rather than to punish wrongdoers.

Three general remedial purposes of an administrative sanction can be identified: (1) to protect investors, (2) to rehabilitate the offender, and (3) to insure voluntary compliance with the law.[63] The Act itself appears to envision the desirability of rehabilitative efforts in section 8.02, which authorizes the CSC to impose conditions on continued registration "including . . . conditions with respect to educational requirements."[64] This technique has been used by the SEC in cases in which it believes that the violation was the result of ignorance rather than malice, and where renewed educational efforts to acquaint the offender with proper procedures may help to "rehabilitate" the offender and thus avoid future violations.[65] Likewise, the protection of the investors is recognized in section 8.02(2) (f), a catch-all provision, which refers to the need for protection of investors as a basis for determining the suitability of a person for registration. Finally, achieving voluntary compliance can be assumed to be a valid purpose of a remedial sanction. Voluntary compliance includes both the general and specific deterrence value of sanctions. For example, it seems unnecessary, perhaps even punitive, to cancel the registration of a first offender if the violation is the result of inexperience, rather than malice, and the offender has made restitution, recognizes the seriousness of the offence and is undergoing retraining.

Admittedly, generalities about remedial purpose are slippery, and the line between punitive and remedial purposes is a fine one. Moreover, generalities will not mechanically decide actual cases. But the attempt to under-

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[61] See, *e.g.*, *Beck* v. *SEC*, 430 F. 2d 673 at 675 (6th Cir. 1970).

[62] *U.S. ex rel. Marcus* v. *Hess*, 317 U.S. 537 at 554, 63 S. Ct. 379 at 389 (1943) (concurring).

[63] See, *supra* note 59, at 721-26.

[64] *Supra* note 1, s. 8.03(3).

[65] See Thomforde, *Negotiating Administrative Settlements In SEC Broker-Dealer Disciplinary Proceedings*, 52 N.Y.U. L. Rev. 237 at 272-73 (1977).

stand and to articulate the purpose for imposing a particular sanction helps focus the decision-making process. Obviously, achievement of the perceived purpose of a sanction requires the decision-maker to develop an adequate factual basis from which to infer that a particular offender "needs" to have a sanction imposed. In turn, this necessitates the introduction of evidence that adequately describes the offence and the offender.[66]

What is being suggested, of course, is that when the CSC institutes a broker-dealer disciplinary proceeding under section 8.02, it should afford an opportunity for the respondent and the staff to introduce evidence that is relevant to the ultimate selection of a sanction. Pursuant to the reasons requirement of section 15.17(8), the decision-maker should explain the desirability and necessity of the sanction imposed in the particular case in light of the substantial evidence and sanction purposes. Indeed, federal courts in the United States have become willing to provide at least a limited review of the adequacy of the factual basis and rationale for the imposition of sanctions.[67] Judicial review of administrative decisions is essentially a requirement that the court be satisfied that the administrative choice is reasonable. Because selection of a sanction is perhaps the most important decision in a broker-dealer proceeding, it is important that the agency make a principled attempt to explain the basis and purposes for imposing a particular sanction.

In a previous article, the author suggested the possibility of formulating guidelines that might provide a framework for ensuring that the selection of sanctions is accomplished with reasonable consistency.[68] The proposed guidelines are not intended to be a mechanical rule that will unerringly decide individual cases; rather, they are intended to provide a framework within which a commission will have reasonable flexibility to tailor a remedy that is justified in light of the purposes of administrative sanctions and the facts of the case, and reasonably consistent with similar cases.

Proposed Sanction Guidelines

(a) In determining an appropriate sanction in any proceeding pursuant to section [8.02] of the Act, the Commission will support its decision to impose (or not to impose) a sanction with adequate findings and reasons to show that it has considered the purpose of the sanction, as well as all relevant factors describing the offense and the offender.

(1) The remedial purposes that a sanction may serve shall include: (A) the protection of investors; (B) the general and special deterrence of future violations; and (C) the encouragement of voluntary compliance with the Act or the rehabilitation of offenders.

(2) Factors describing the offense shall include: (A) the seriousness of the offense; (B) the number of investors involved or affected; (C) the amount of money involved; (D) the financial losses [*sic*], actual or threatened, to investors; (E) the profit to the offender; (F) the geographic scope of the violation; and (G) all other relevant factors consistent with the purposes of this Act.

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[66] See, *supra* note 59, at 726-29.

[67] See, *e.g.*, *Beck* v. *SEC*, *supra* note 61, at 675.

[68] *Supra* note 59, at 716-33.

(3) Factors describing the offender shall include: (A) former violations; (B) general reputation in the industry; (C) age and experience in the securities business; (D) willfullness [*sic*] of the offense; (E) willingness to reform or make restitution; and (F) all other relevant factors consistent with the purpose of this Act.

(b) In the case of an individual, [cancellation] will be an appropriate sanction where—

(1) there is a reasonable likelihood that the respondent will continue to violate the securities laws; or

(2) there was an intentional or gross disregard for the requirement of the securities laws; or

(3) for other good cause shown.

(c) In the case of a registered broker-dealer, revocation will be an appropriate sanction where—

(1) there was substantial participation by management in the violation under circumstances stated in (b) above; or

(2) there was gross disregard of the duty to supervise prescribed by . . . the Act; or

(3) for other good cause shown.

(d) In the case of financial loss to investors, restitution or an offer of restitution will not mitigate the offense, except for good cause shown, when [cancellation] would otherwise be an appropriate sanction pursuant to the requirements of paragraphs (b) and (c) of this rule.

(e) Any person whose registration has been [cancelled] may petition the Commission for a hearing to consider readmission to the securities business. No such petition may be considered earlier than one year after the imposition of the sanction. The Commission will support its decision to deny a hearing, or to deny readmission after a hearing, with findings and conclusions not inconsistent with the purpose of this Act or this rule.

(f) In any proceedings pursuant to this rule, the Commission will explain departures from prior policy, whether that policy is embodied in written opinions or otherwise.[69]

The rule is intended to impose upon the decision-maker two principal obligations. First, it requires the commission to make findings of fact that describe both the offence and the offender. Second, it requires the commission to demonstrate the necessity of imposing a particular sanction in light of both the findings of fact and the articulated purposes that it believes are to be served by the sanction. The rule requires the findings to be supported by substantial evidence, thus providing a basis for limited judicial review of action that is allegedly arbitrary, capricious, or an abuse of discretion.

C. *Negotiated Settlements*

One enforcement option available to the CSC, and related to the sanctioning question, is the negotiated settlement of cases.[70] Negotiated settlements are a fact of life for law enforcement agencies with large caseloads and limited resources. Further, if an offender is willing to settle a case and voluntarily accept the imposition of a sanction, thus saving the state the time and expense of prosecuting a violation, settlements seem to be unobjectionable.

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[69] *Id.* at 731-33.

[70] In a criminal proceeding the analogous term would be "plea bargaining;" in an injunctive proceeding, the analogous term would be "consent decree."

There is, however, the potential for abuse. One problem is whether the opportunity to settle will be available to all persons equally. The *Draft Act* does not specifically provide for a settlement opportunity. Given the importance of the procedure, there is a need for the CSC to develop a principled framework within which a settlement can be discussed and an appropriate sanction negotiated.

For convenience, settlements can be categorized as either formal or informal. A formal settlement has two characteristics: (1) the CSC has begun a formal administrative action (for example, a section 8.02 broker-dealer disciplinary proceeding) and (2) the offender voluntarily accepts the imposition of a formal sanction prior to adjudication. An informal settlement has two characteristics: (1) the CSC has evidence of a violation but has not instituted any formal enforcement action and (2) the case is closed without formal enforcement action and without the offender receiving a formal sanction. The offender agrees, however, to take certain corrective measures.

1. Formal Settlements

In the United States, an opportunity to negotiate a formal settlement is specifically required by the *Administrative Procedure Act*[71] and the Commission's own rules.[72] Formal settlements are a significant enforcement option; at least eighty percent of all SEC enforcement actions are settled, or consented to, without the need for full adjudication.[73] As in the case of informal settlements, formal settlements result in desirable savings for both the government and the respondent.

The formal settlement is important, however, not simply because it avoids the time and expense of a formal adjudication. A study of SEC practice reveals that the sanctions imposed in formal settlements are less severe than the sanctions that are imposed following contested adjudications.[74] Not only are the sanctions less severe in general, but it appears that the sanction of suspension, rather than cancellation, is, as a practical matter, limited to non-contested cases.[75] The SEC's willingness to impose conditions on the registrant, rather than to cancel the license, is also more frequently found in the settled cases.[76] Even when the sanction is cancellation, it is frequently a limited cancellation providing a specific opportunity to apply within a year for readmission.[77] Thus, formal settlements may represent not only a saving in time and expense, but may also result in less severe sanctions.

There are, however, problems associated with the formal settlement procedure not unlike those associated with informal settlements. First, there is

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[71] 5 U.S.C. § 554(c)(1) (1966).

[72] 17 C.F.R. § 201.8(a) (1979).

[73] *Supra* note 65, at 267.

[74] *Id.* at 267-73.

[75] *Id.* at 268.

[76] *Id.* at 272-73.

[77] *Id.* at 269-70.

some evidence that a negotiated formal settlement is not always available on a consistent basis.[78] Second, some securities lawyers claim that, despite available defences, they consent to the imposition of sanctions simply to avoid further investigation and harassment by the staff.[79] Finally, if the staff is under no obligation to discuss the facts of a case with the offender, as is the case in the United States,[80] the offender's ability to meaningfully negotiate a settlement is limited. Given the importance of formal settlements, the CSC should at least promulgate a rule that describes the availability of the procedure.

2. Informal Settlements

If the CSC's investigation produces evidence of a violation, the case may be closed without taking formal enforcement action. First, the evidence may be legally insufficient. Second, the matter may be referred to another enforcement agency for prosecution. Third, private litigation may be adequate to meet the agency's enforcement goals.[81] A study of SEC practices has revealed a fourth category.[82] The study showed that over forty percent of cases that were closed without prosecution were closed despite the fact that the evidence was sufficient to prove a violation and despite the fact that no other state or self-regulatory group was prosecuting the matter.[83] In particular, the analysis of SEC reasons for closing such cases without prosecution indicated three basic fact patterns that characterized cases that were informally settled.[84] First, the violation had a *de minimis* effect on investors, either because the violation was an isolated event, or involved few investors, or a small sum of money, or was the result of inadvertence. Second, the offender had voluntarily stopped the violation or had corrected the unlawful behaviour upon noticing it. Third, there was no financial loss to investors. Any combination of these three critical factors might have been present in a given case. In most of these cases the offender privately agreed with the staff of the SEC, sometimes in writing,[85] to undertake to institute new procedures to prevent similar violations in the future, or to make restitution in the event that some small amount of money had been lost by investors.

The informal settlement practice of the SEC is not improper. The staff of the SEC obviously has discretion not to prosecute. In certain cases, particularly those in which the SEC tends to agree to informal settlements, the process, in general, seems to be both appropriate and desirable. The SEC study revealed potential dangers, however.[86] Outside an experienced group

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[78] See, *supra* note 57.

[79] *Supra* note 65, at 274-75.

[80] 17 C.F.R. § 202.5(c) (1979).

[81] See, *supra* note 65, at 243-44.

[82] *Id.*

[83] *Id.* at 244.

[84] *Id.* at 245-46.

[85] Written agreements are sometimes referred to as "undertakings."

[86] See, *supra* note 65, at 247-51.

of sophisticated securities law practitioners, the process is not well known, thereby limiting its availability to all similarly situated offenders. Even to the extent that the process is known, the ability of an offender to agree informally to settle the matter without formal prosecution requires that the offender know that he is the subject of an investigation and that the staff is contemplating formal enforcement action. Frequently, however, offenders do not know that enforcement action is contemplated until the matter has already been formally set down for administrative, criminal or civil prosecution. In such cases, obviously, the opportunity for informal settlement is lost. Finally, there appears to be some inconsistency in the availability of the procedure, and, in some cases, SEC attorneys deny that the practice exists. Informal settlements serve the interests of the securities commission, the offender, and the public. It is suggested that the procedure be formally recognized and made available to all persons on an equal basis.

In a previous article, the author suggested a tentative set of guidelines that might provide a framework within which informal settlements could take place.[87] Such guidelines would have the benefit of encouraging greater consistency in the use of the procedure, as well as providing notice to affected parties of its availability.

Staff Decisions Not To Recommend Formal Enforcement Proceedings

1. The staff may, on its own initiative or at the request of a party, elect not to recommend formal enforcement proceedings where:
   a) The impact of the violation on the investing public is *de minimis* (factors to be considered include, but are not limited to, the number of investors involved, the amount of money involved, and the amount of loss, if any, incurred by investors); and
   b) The party evidences a willingness to comply with the securities laws (factors to be considered include, but are not limited to, the party's candor and cooperation during investigation, prompt cessation of illegal activities, willingness to adopt necessary remedial changes to prevent future recurrences, and willingness to make restitution); and
   c) any other factors present in the case that make an informal settlement consistent with the purposes of the securities laws and these guidelines.

2. A decision not to recommend formal proceedings will be inappropriate where there is a reasonable likelihood of future violations as evidenced by prior record, or intentional or gross disregard for the law.

3. A party may submit a written statement describing all factors, consistent with section 1 above, that it desires the staff to consider in reaching a decision. In addition, a party may state any relevant terms or conditions, to which he/she is willing to agree, that will tend to insure that the purposes of the securities laws will be achieved.

4. In the event the staff decides not to recommend formal enforcement proceedings, it shall submit a recommendation to the Commission, signed by the party, supported by reasons consistent with sections 1 and 2 above.

5. Summaries of all recommendations and reasons that are approved by the Commission shall be published as Commission releases, after deleting facts which identify the party.[88]

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[87] *Id.*

[88] *Id.* at 250-51.

The guidelines are based on the SEC's practice and experience.[89] Thus, the informal settlement procedure should be available only where the effect on the investing public is *de minimis* and the party evinces a willingness to comply with the securities laws, therefore making formal action unnecessary to protect the public. There are, however, circumstances where an informal settlement might not be appropriate, and section 2 of the above guidelines suggests one such limitation.

Another important aspect of the guidelines is the requirement that the commission summarize the factors and reasons that warrant closing a case without formal prosecution and make those reasons publicly available. The reasons of the commission in these cases will become the common law in the field and both the staff and the affected parties should have access to the "law" in order to determine whether a case fits within the guidelines.

IV. CONCLUSION

The administrative enforcement procedures provided for in the *Draft Act* are not dissimilar to the procedures available in the United States and in the Canadian provinces. The powers to investigate, prosecute and impose administrative sanctions are crucial discretionary powers. The agency must bear the responsibility for insuring that those discretionary powers are exercised with an even hand. The CSC ought to consider the development of enforcement manuals, guidelines, and rules that will assist the staff in making enforcement choices, and insure that the regulated parties understand their rights.

The need is particularly acute in the area of administrative sanctions. In this context, the CSC has its greatest power: the ability to deprive one of a license to do business. If agencies are to maintain public respect for their law enforcement efforts, and if courts are to meaningfully perform their responsibility of judicial review of agency action, it is crucial that the agencies be more sensitive to the need to articulate the reasons for their important discretionary choices and the standards that guide the exercise of discretion. Without this sensitivity, the danger of creating the appearance or suspicion of impropriety will persist, and, in some cases, either inadvertence or neglect will create the reality of abuse.

[89] That is, an analysis of actual cases developed the patterns of practice which are, in effect, codified by the guidelines. Section 5, which requires that summaries of the reasons be publicly available, is not an existing SEC practice, however.