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Introduction

The last decade has witnessed an unprecedented level of securities fraud, involving some of Canada's largest brokerage firms. Executives from Thomson Kernaghan & Co, Norbourg, Essex, Farm Mutual, iForum, and Triglobal were all either tried and convicted by the criminal justice system (CJS) for committing *Criminal Code* offences, or were sanctioned by the provincial securities commissions ("Commissions") and self-regulatory organizations ("SROs") for violating regulatory offences (see Canadian Foundation for Advancement of Investor Rights (FAIR Canada), 2011a: 17-20). In the cases where criminal convictions were secured, the sentences imposed and the actual time spent in prison was too lax to offer any serious deterrent effect (p. 27). In terms of regulatory enforcement, the "fines imposed by securities regulators were often not collected, and the laxity of sanctions imposed, if any, did not send a sufficiently strong deterrence message to market participants or the public" (FAIR Canada, 2011a: 27; also see Baines, 2007; Lokanan, 2012).

To combat this problem, some have argued for Canada to have a national securities regulator (Bhattacharya, 2006; MacNeil & Solomon, 2008).[1] However, countries (for example the United States (U.S.) and United Kingdom (U.K.)) that already have national securities regulators also face legitimate enforcement concerns. What we have seen with the Securities and Exchange Commission ("SEC") and the Financial Services Authority ("FSA") [2] in both the U.S. and the U.K., is that regulatory efforts fall short of meeting the purpose that the statues are aimed to address, creating a perverse effect and endangering enforcement goals. The SEC for instance, has often been cited for conspicuous failure and inefficiencies that undermine its legitimacy (Shapiro, 1984;

Gray, Frieder, & Clark, 2005). One of the many complaints is the "command-and-control" rule book oriented strategies that dictate the SEC's regulatory goals. The SEC's punitive enforcement approach engenders resistance, which creates a reduced incentive to cooperate with regulators. The same can also be said for the now defunct FSA.

Perhaps, a more systematic and innovative approach to securities regulation is found in Ayres and Braithwaite's (1992) work on responsive regulation (Simpson, 2002: 99). Ayres and Braithwaite's (1992) model focuses on dialogues and collaborations that maximize the role of responsive regulation, and minimize the role of the CJS. This is not to say that the model explicitly minimizes the role of criminal charges per se, but rather the use of punitive measures more generally (criminal or otherwise).[3] It is contended that regulatory objectives can be met when enforcement agencies display a pyramid with varying degrees of interventionism. The pyramid of sanctions as it is called, "suggests that the greater the heights of punitiveness to which an agency can escalate, the greater its capacity to push regulation down to the cooperative base of the pyramid (Ayres & Braithwaite, 1992:40).

This brief paper seeks to open a preliminary conversation of responsive regulation within an inter-agency framework in the financial sector. To start, I use the SRO that is responsible for governing Canada's investment dealers and brokerage firms – the Investment Industry Regulatory Organization of Canada ("IIROC") as a prototype example where responsive regulation can be applied. IIROC was formed in June of 2008 from the merger of the Investment Dealers Association ("IDA"), the SRO responsible for regulating investment and brokerage firms in Canada and Market Regulation Services Inc. ("RS"), the SRO responsible for regulating the marketplace. As a national SRO,

IIROC is one of the two major SROs (the other is the Mutual Funds Dealers Association ("MFDA") that is responsible for regulating mutual fund dealers in Canada) entrusted with the task of overseeing Canada's investment and securities markets. IIROC regulates broker-dealer firms ("Dealer Members") and their employees ("individual registrants") who sell brokerage and investment services to prospective investors.[4] As it now stands, IIROC is recognized as an SRO by all of the Commissions across Canada and operates under Recognition Orders from the Canadian Securities Administrators ("CSA")[5] (IIROC, 2009: para. 1). IIROC in turn, sets educational requirements, ethical standards, and compliance rules that govern the conduct of individual registrants and Dealer Members. Individual registrants and Dealer Members must comply with these rules, or face penalties for violations that range from a written reprimand, to permanent bans from participating in the market (see IIROC, 2008: 4). IIROC's nine District Councils across Canada are responsible for enforcing these rules.

My thesis is simple: I argue that responsive regulation, that is, regulators willingness to be responsive to the context, culture, and conduct of market participants, is a promising strategy to regulate in the public interest. More specifically, the paper argues that Ayres and Braithwaite's (1992) model of governance can be used to discover and develop strategies for deterring investment fraud through the network of relations and capacities within the securities industry. To be responsive would require IIROC to indicate a willingness to escalate intervention up the pyramid, or to deregulate down the pyramid in response to their members' compliance with regulatory objectives.

There have been few if any attempts to extend Ayres and Braithwaite's (1992) model to the financial sector. In this sense, the paper makes both a theoretical and

practical contribution to the existing literature. Theoretically, the effort to situate IIROC within the larger context of securities regulation in Canada, and to acknowledge the impact of inter-agency dynamics including forms of both conflict and mutual interdependency, is a move that has never been attempted by regulatory scholars before. This inter-agency dynamic further complicates the responsive regulation framework, which has been developed largely in reference to single agencies. The present paper transcends this approach and pays attention to jurisdictional boundaries to ensure that local-level information is valued and that inter-agency relationships have some legitimacy in the governance of financial markets (Ford, 2013). Practically, the paper builds on the theoretical discussion and responds to recent calls (Kingsford-Smith, 2004, 2011; J. Braithwaite, 2012; Williams, 2012a; Ford 2013; Findlay, 2014) for studies to recommend ways in which responsive regulation as a governing mechanism may be encouraged within an inter-agency regulatory framework. While the theory aspires to general applicability, particular consideration is given to its ability to govern market participants with stakes in the regulatory game (see Ford, 2013).

The rest of the paper is organized as follows: proceeding the introduction, I begin by providing a brief overview of securities governance and the problems with regulatory failure in Canada. The paper is informed by the lessons from IIROC's enforcement activities and identifies the critical factors that contributed to the laxity of sanctions imposed by IIROC's hearing panels. I then outline the concept of responsive regulation, sketch its theoretical underpinnings, and explain the key features of the model. Next, I present an analysis of the criticisms surrounding responsive regulation. In addressing the criticisms, I highlight the main arguments and address the concerns that are raised for

regulating responsively. This is followed by a brief literature review of some of the major works on the application of responsive regulation in various industries. I then examine the suitability of responsive regulation as a regulatory technique to secure compliance. Here it is argued that IIROC is well positioned within Canada's inter-agency regulatory framework, to apply the two key elements of responsive regulation: the role of the regulator (in Canada's case, the Commissions and the Royal Canadian Mounted Police's (RCMP) Integrated Market Enforcement Team (IMET)) as the "benign big guns" that carry big sticks, and the ability of IIROC to start at the base of the pyramid and "speak softly" to secure compliance. Finally, the conclusion highlights areas for future research.

Understanding Enforcement in Canada

Securities Governance and the Problem of Regulatory Failure

In Canada, several regulatory agencies share the responsibility for enforcing securities laws. These agencies are embedded in a maze of regulations that are made up of the police and Commissions, who are both, involved in a complex and fragmented system of regulation comprising multiple rules and decision makers (Bhattacharya, 2006: 6). The sheer number of players operating in the securities arena, demands a brief review of the relationships between these agencies, the manner in which they seek to enforce their statutory mandates, and their scope and jurisdictions.

Within the Canadian regulatory landscape, the Commissions and SROs have their own rules and regulations that govern the markets. Securities law violations can be effected through administrative proceedings by the Commissions and SROs. Administrative decisions and sentence orders meted out from administrative hearings range from disgorgement, fines (up to $1million) and cost payments, reprimands, and

conditions and orders prohibiting individuals from trading in securities (FAIR Canada, 2011a: 23).

Violations of provincial securities legislations and SROs' rules can also be prosecuted in provincial courts as quasi-criminal offences. A quasi-criminal offence is a misconduct that has an element of criminal or quasi-criminal activity attached to it. Quasi-criminal offences include but are not limited to fraud, forgery, false endorsement, misappropriation of funds, and securities act breaches (see IIROC, 2009: 16-20). Quasi-criminal offences are punitive in nature, and as such, their proceedings are commenced in provincial courts under provincial securities acts rather than under the *Canadian Criminal Code* (FAIR Canada, 2011a: 23). Sanctions for quasi-criminal offences include "fines (up to $3 million in British Columbia and $5 million in several other provinces); prison terms for a maximum of five years less a day; payment of triple the amount of the profit made or the loss avoided; disgorgement; and payments of restitution or compensation" (p. 23).

As with most white-collar crimes, the more serious securities violations can stimulate a range of official responses from SROs and provincial securities commissions' investigations and hearings, to criminal prosecution (Beresford, 2003: 93). It is rare however, that all three agencies will commence a hearing on a criminal offence. By law, the provincial securities commissions and SROs are required to refer the cases with evidence of criminal activities to IMET for further investigation. The prosecutions for violations of Canadian *Criminal Code* offences such as fraud affecting the public market, market manipulation, and false prospectuses can carry sanctions that include up to fourteen years imprisonment and fines (FAIR Canada, 2011a: 23).

This “enforcement mosaic” has been criticized for being lax and in need of repair (see Bhattacharya, 2006: FAIR Canada, 2011a: Williams, 2012b; Lokanan, 2012). A myriad of reasons has been put forward for the claim that securities regulators have fallen short of their governance mandates in Canada. For many, the issues are not so much inefficiencies by the agencies, but perceived unfairness and bias in the regulatory process itself (Cory & Pilkington, 2006; Williams, 2012b: 3). Here, regulators are chided for taking on only the overly egregious cases, which puts the market into disrepute, while at the same time, subjects so-called legitimate industry players to overly aggressive and unfair regulatory encroachment (Williams, 2012b: 3). There is also the problem of which agency has jurisdiction over the cases. In the regulatory game of securities regulation, cases often get juggled around, with multiple over lapping sources of regulatory scrutiny that creates a regulatory burden (Beresford, 2003; Carscallen, Gray, & Pink, 2003). From the investors’ point of view however, the issue is not so much the burdensome nature of the regulation, but the failure of the regulatory agencies to investigate, prosecute, and provide restitution in cases of misconduct brought forward by investors (Williams, 2012b: 3). This weakness is highlighted in IIROC's operations with respect to securities law violations and its enforcement activities.

The Enforcement Problem as it Pertains to IIROC

Table 1 Regulatory Violations Prosecuted by IIROC for Individual Registrants

Types of Violations	2103		2012		2011		2010		2009	
	N	Percent	N	Percent	N	Percent	N	Percent	N	Percent
Due Diligence/Suitability	19	29%	26	28%	20	23%	15	18%	12	30%
In appropriate financil dealings	7	11%	10	11%	9	10%	10	12%	5	13%
Misappropriation	3	5%	8	9%	5	6%	2	2%	2	5%
Misrepresentation	3	8%	9	10%	5	6%	9	11%	3	8%
Discretionary trading	5	5%	6	6%	5	6%	4	5%	0	0%
Forgery	3	5%	6	6%	2	2%	4	5%	1	3%
Unauthorized trading	1	2%	6	6%	7	8%	5	6%	0	0%
Manipulation	3	5%	4	4%	9	10%	2	2%	0	0%
Outside business activities	4	6%	4	4%	2	2%	1	1%	0	0%
Supervision	4	6%	4	4%	5	6%	2	2%	4	10%
Gatekeeper	2	3%	3	3%	5	6%	6	7%	4	10%
Fail to cooperate	3	5%	2	2%	7	8%	7	8%	4	10%
Trading conflict of interest	0	0%	2	2%	0	0%	4	5%	0	0%
Off book transactions	5	8%	1	1%	3	3%	6	7%	2	5%
Trading order violation	0	0%	1	1%	2	2%	0	0%	0	0%
Trading without registration	1	2%	1	1%	2	2%	3	4%	1	3%
Fraud	2	3%	0	0%	0	0%	1	1%	0	0%
Undisclosed conflict of interest	0	0%	0	0%	0	0%	2	2%	2	5%
Total	65	100%	93	100%	88	100%	83	100%	40	100%

Source: IIROC's (2013). "Enforcement Report," page 27.

According to its annual enforcement report, IIROC oversees about 200 Dealer Members and 29,000 investment advisors across Canada (IIROC, 2013). One yardstick to measure IIROC's success in policing its members is to look at its enforcement activities. As can be seen in Table 1, over 50% of all complaints brought against individual registrants from 2009 to 2013, related to suitability violations, inappropriate financial dealings, misrepresentations, and misappropriation of funds.

Table 2: Regulatory Violations Prosecuted by IIROC for Dealer Members

Firms										
Type of Violation	**2013**		**2012**		**2011**		**2010**		**2009**	
	N	**Percent**	**N**	**Percent**	**N**	**Percent**	**N**	**Percen**	**N**	**Percent**
Supervision	5	42%	10	50%	9	36%	2	33%	6	38%
Expedited hearing - Firms winding dow	1	8%	3	15%	0	0%	0	0%	0	0%
Failure to handle clients accounts	0	0%	2	10%	2	8%	1	17%	0	0%
Failure to meet best price obligations	0	0%	2	10%	3	12%	2	33%	0	0%
Inadequate books and records	0	0%	1	5%	4	16%	0	0%	0	0%
Internal controls	2	17%	2	10%	3	12%	1	17%	3	19%
Capital deficiency	4	33%	0	0%	4	16%	0	0%	7	44%
Total	12	100%	20	100%	25	100%	6	100%	16	100%

Source: IIROC's (2013). "Enforcement Report," page 27.

Enforcement work pertaining to Dealer Members revolved around familiar themes from previous years. As can be seen in Table 2, Failure to Supervise (brokers for marketing and selling nontraditional investments) made up more than one-third of all of the violations committed by Dealer Members.

Weak Enforcement with no Compliance Impact

Table 3 Fines, Costs, Disgorgement and other Non-Monetary Penalties Imposed on Individual Offenders

Sanction Imposed by IIROC's Hearing Panel on Individual Offenders									
	Monetary Penalties				Non-monetary Penalties				
Year	**Decisions**	**Fines**	**Costs**	**Disgorgement**	**Suspension**	**Permanent bar**	**Warning letter**	**Conditions**	**Total non-monetary penalties**
2009	28	$ 1,535,000	$ 422,178	$ 29,076	8	7	8	16	
2010	45	$ 2,704,853	$ 536,500		17	17	17	15	
2011	58	$ 6,413,129	$ 815,050	$ 627,039	19	11	5	25	
2012	56	$ 9,770,355	$ 623,167	$ 142,189	34	9	18	20	
2013	45	$ 4,382,500	$ 655,454	$ 220,117	25	8	5	23	
Total	**232**	$ 24,805,837	$ 3,052,349	$ 1,018,421	103	52	53	99	307
Percentage of Non-Monetary Penalties					34%	17%	17%	32%	100%

Source: IIROC's (2013). "Enforcement Report," page 28.

IIROC seems to rely on more persuasive oriented penalties to deal with the offences committed by individual registrants and Dealer Members. As can be seen in Table 3 and 4, the majority of non-monetary sanctions imposed on registrants, seemed more compliance oriented. For this group of registrants, IIROC's role was to encourage

remedial action in the hopes that such actions assisted in awareness building and helping them to continue to comply. Then there are those registrants who were prepared to circumvent the rules if the odds are in their favour to get away with rule violations. IIROC's strategy with this group was to have them reflect on their conduct by imposing civil penalties in the form of fines, costs and disgorgements. For the more serious rule violations, IIROC used its full enforcement strength (license suspension and permanent bans) to regulate this group. In summary, it would appear that the more severe sanctions were used only occasionally, while intermediate sanctions occupied a larger share of IIROC's enforcement activity.

Table 4 Fines, Costs, Disgorgement and other Non-Monetary Penalties Imposed on Dealer Members

		Sanction Imposed by IIROC's Hearing Panel on Dealer Members						
		Monetary Penalties			Non-monetary Penalties			
Year	Decisions	Fines	Costs	Disgorgement	Suspension	Termination	Warning letter	Total non-monetary penalties
2009	15	$ 32,530,000	$ 369,853		4	1	6	
2010	6	$ 1,297,500	$ 369,853		1		2	
2011	18	$ 1,525,000	$ 162,000	$ 1,768	1	2	1	
2012	16	$ 1,361,667	$ 259,333		4		1	
2013	12	$ 2,220,000	$ 100,000	$ 310,000	3	2	2	
Total	**67**	$ 38,934,167	$1,261,039	$ 1,768	13	5	12	30
Percentage of non-monetary penalties					43%	17%	40%	100%

Source: IIROC's (2013). "Enforcement Report, " page 28

This enforcement strategy leads to criticisms of IIROC as an ineffective and lax regulator (FAIR Canada, 2011a; 2011b). Central to these criticisms is that penalties imposed by IIROC are often not proportionate to the offences, resulting in there not being any deterrent effect (FAIR Canada, 2011a: 27). Penalties such as warning letters, terms

and conditions, and limited suspensions are seen as nothing more than a regulatory wrist-slap. With the exception of Dealer Members (and the proportion of permanent suspensions imposed), IIROC seldom imposes harsher sanctions, thereby attenuating its reputation and rendering ineffective its effort to regulate in the public interest (also see Rawlings, 2007). The availability of rules and penalties are important not so much for their deterrent effect, but because of their moral impact in legitimating the substantive content of the message (Parker, 2006: 617). However, regulators who do not have the statutory authority to enforce the penalties imposed, certainly, will be seen as lacking the credibility as an enforcer.

Lack of Legitimacy Leading to Emasculation

As mentioned earlier, IIROC is embedded in a maze of regulation where it depends on the Commissions and IMET to successfully execute its mandate. The Commissions and IMET are distinguished by their enormous power: the Commissions to revoke licenses and enforce fines levied on market participants; and, the power of IMET to pursue criminal convictions. As core members of Canada's securities regulatory landscape, the Commissions and IMET almost never use their powers (see Marquis, 2009; Williams, 2012b; Canadian Broadcasting Corporation, 2012).

IIROC's inability to escalate sanctions to more serious penalties, arguably, could be a direct result of the Commissions and IMET's failure to wield their powers and cooperate with IIROC's mandate. Given the degree of overlap in the regulatory system and the need for cooperation to secure compliance, a frequent complaint by IIROC is that the Commissions are prone to step on its turf and assume control of cases that are rightfully in its jurisdiction (Williams, 2012b: 75). One would assume that there is some

collegiality in the "enforcement mosaic," but as the following reveals, there does not seem to be any (Bhattacharya, 2006). The possibility of the Commissions stepping in to take over cases is highlighted by one of IIROC's regulators:

> We have got personal experience with that where very interesting cases come up and we were in the process of doing something and inform them because there's going to be a piece of it that's coming to them, and it's just taken. And nothing's happened (interviewee's response, as cited in Williams, 2012b: 75).

The move to step on IIROC's turf and adopt a non-cooperative stance toward compliance goals has critical implications. Most profound among these, is the limiting effect that the turf war has for IIROC as a regulator. IIROC is dependent upon the Commissions to act as a "benign big gun" and address cases where registrants refuse to comply. However, the inter-agency conflict between the Commissions and IIROC, and the former's reluctance to cooperate in the regulatory mix, contributes to IIROC's failure to secure compliance in some of the more serious cases of transgression.

Neither IIROC nor the Commissions have the legislative authority to pursue criminal prosecutions. Ordinarily, individual registrants and Dealer Members who are involved in cases with provisions that may under normal circumstances be enforced by criminal prosecution, and failed to comply despite cooperative efforts, will have their cases forwarded to the police. However, there is evidence to suggest that the police in general and IMET in particular, are not at all interested in taking on cases from IIROC. Exactly the kinds of cases that IIROC is castigated for in failing to secure compliance (see Snider, 2009). As one securities fraud lawyer noted,

> one of the most common complaints directed by regulators towards IMET is their unwillingness to take on smaller files with clear criminal overtones: 'IMET don't touch anything unless it involves multi-millions of dollars whereas the small frauds,

> they don't have time for'" (interviewee's response, as cited in Williams, 2012b: 72).

Perhaps this is because the cases typically referred by IIROC for criminal or quasi-criminal charges tend to involve fairly small, marginal players who have proven unresponsive to previous disciplinary measures. These types of charges are rarely if ever contemplated for the larger, mainstream players engaging in what are arguably more damaging activities (e.g. unsuitable investment advice), not because the Commissions and IMET are unwilling to take them on but rather because these are viewed by IIROC itself as non-criminal matters. Consequently, it may very well be the case that IIROC is a lax regulator; however, this is not necessarily reducible to the failure of the Commissions and IMET to pursue criminal charges at the agency's behest.

In the absence of support from the Commissions and IMET, IIROC's other option is to enforce the law "softly" and therefore ineffectively (FAIR Canada, 2011a, Lokanan, 2012). Generally, this means that IIROC is pigeonholed into a position where it is pursuing just enough enforcement to satisfy the requirement of its governance mandate, but not necessary to prevent investment fraud. Following from this, the more accurate conclusion would thus be that IIROC may be ineffective because it is unable to address the more serious and systemic industry problems, not because of its failure to regulate in the public interest. Adopting this course of action results in IIROC being forced to address cases that should have been given harsher sanctions with more compliance oriented strategies. Responsive regulation takes into account this problem and is positioned to envision a framework that stresses the importance of this distinct challenge that regulators face in the regulatory process (Ford, 2013).

Theoretical Framework and Prior Research

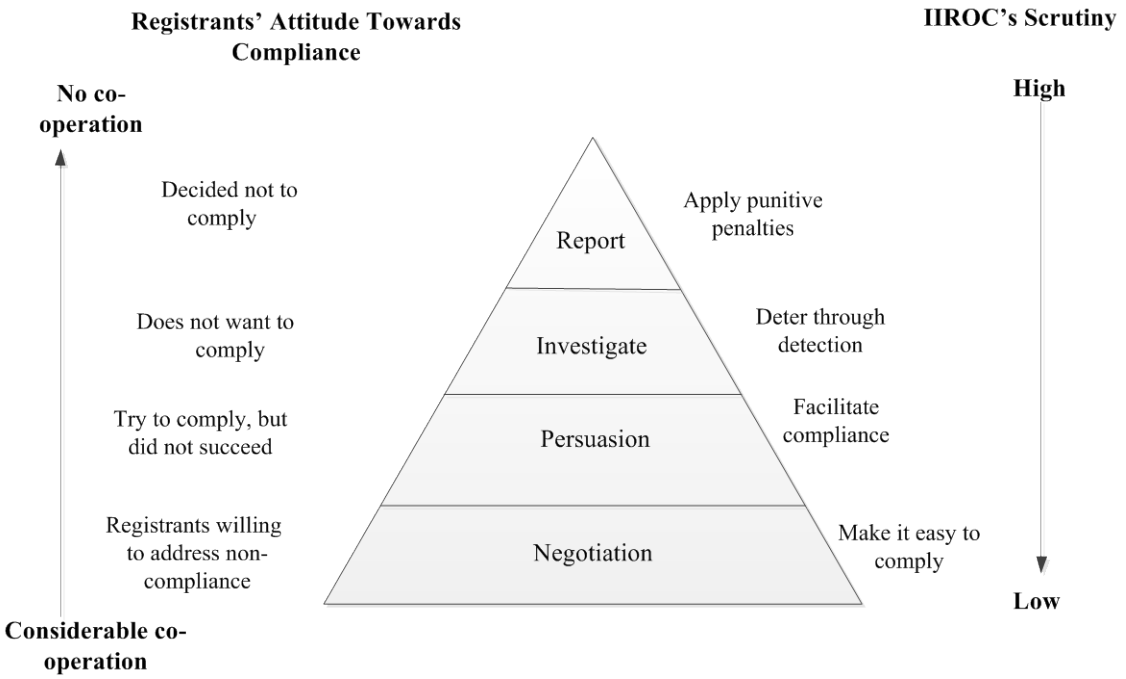
Responsive Regulation: Its Scope and Features

Responsive regulation links the notion that regulatory styles, which are cooperative on the one hand and consist of credible punitiveness on the other, "may operate at cross-purposes because the strategies fit uneasily with each other as a result of conflicting imperatives (Ayres & Braithwaite, 1992: 5). Central to this long standing dispute are academic scholars and regulators, "who think that corporations will comply with the law only when confronted with tough sanctions and those who believe that gentle persuasion works in securing business compliance with the law" (Ayres & Braithwaite, 1992: 20; also see Baldwin & Black, 2008; Kingfords-Smith, 2011; Ford, 2011; Findlay, 2014). Ayres and Braithwaite (1992) transcend this "crude polarization of regulatory enforcement" and argue that "regulatory agencies that do best of achieving their goals are those that strike some sort of sophisticated balance between the two models" (p. 21). Along these lines, the crucial question for Ayres and Braithwaite was: "when to punish and when to persuade?"

To answer this question, Ayres and Braithwaite (1992) use a game theory called tit-for-tat ("TFT").[6] That is, firms are seen as rational actors and therefore, should be trusted until they defect. The rationale behind this approach is that regulation is a changeable process, and as such, a TFT strategy may maximize regulatory efficiency and compliance (Lee, 2008: 748; Simpson, 2002: 114). In the first instance, regulators enforce "by compliance strategies, but apply more punitive deterrent responses when the regulated firms fail to behave as desired" (Baldwin & Black, 2008: 5).

Ayres and Braithwaite's (1992) preferred strategy to entice compliance is for regulators to display an enforcement pyramid of mixed regulatory sanctions – ranging from persuasion at the base of the pyramid, through to warning and civil penalties, up to criminal penalties, license suspension, and then license revocation at the apex (see Figure 1). The pyramid of sanctions assumes that managers are rational actors. As such, compliance is more likely to occur with a "benign big gun" strategy (Parker, 2006: 592-593). Regulatory agencies are more likely to secure compliance when they have tougher sanctions at the apex of the pyramid. That is to say, regulators will be able to speak more "softly" when they carry big sticks. Paradoxically, the bigger the stick, the greater the success regulators will achieve by speaking softly and therefore, it is less likely that they will have to impose tougher sanctions (Ayres & Braithwaite, 1992: Ch. 2).

FIGURE 1
Proposed IIROC's Compliance Framework



However, responsive regulation is not soft regulation. It reserves the harshest penalties “for the calculating recidivist and the completely incompetent subjects of regulation: prosecution and/or incapacitation” (Kingsford-Smith, 2011: 702). There is the presumption that under certain circumstances, regulation at the base of the pyramid may fail. For the minority of recalcitrant individuals who fail to comply with the restorative approach, the regulator will take a more deterrence-oriented strategy by escalating up the pyramid. Human beings respond to different motivations. If at this stage the individual(s) shows signs of reform, responsive regulation means that he/she/they must move down the pyramid. The pyramid is firm, yet forgiving. The pyramid rewards reform and in the process, acknowledges the effort that the individual has made to comply (Braithwaite, 2003: 30-31). If the individual proves to be irrational (unwilling to reform and illicit repair because of his or her contempt for regulation), he or she will be escalated further up the pyramid to threats and actions of increased severity (p. 32). The model does not assume that firms should be dealt with at one level of the pyramid by one enforcement or compliance strategy alone. Rather, the model assumes that the firms are regulated responsively (and therefore effectively) by different strategies at different times, depending on their responses to different levels of regulatory intervention (Ayres & Braithwaite, 1992).

Ayres and Braithwaite’s (1992) model has been expanded in a number of ways. Gunningham and Grabosky’s (1998) "smart regulation" take responsive regulation a step further by using multiple policy instruments and a broader range of regulatory actors to produce a more imaginative, flexible, and pluralistic approach to regulation. Baldwin and Black (2008) in “really responsive regulation,” also add to responsive regulation by

stressing the case for regulators to be responsive to the operative and cognitive frameworks of firms and the institutional environments and strategies that shape the firm's operations. According to Baldwin and Black (2008), ''[r]egulation is really responsive when it knows its regulatees and its institutional environments, when it is capable of deploying different and new regulatory logics coherently, when it is performance sensitive and when it grasps what its shifting challenges are'' (2008: 94). In a further extension of "really responsive regulation," Black and Baldwin (2010) introduced "really responsive risk-based regulation" to manage risks and uncertainty in regulatory systems. Combining

> these two concepts allow risk-based regulation to shift from a mechanical mode of regulation using quantitative approaches towards risk evaluation. Each of these regulatory models envisage a pyramid shaped distribution of regulatees and corresponding regulatory tactics and strategies (Gracia & Oats, 2012: 306).

Responsive regulation, despite its extensions however, has been subject to a number of criticisms.

Responding to the Criticisms of Responsive Regulation

The criticisms surrounding responsive regulation fall into three groups: policy, practical, and constitutional (see Black 1997; Haines 1997; Gunningham & Grabosky 1998; Yeung 2004; Parker 2006; Rawlings 2007; Baldwin & Black, 2008; 2010). With respect to policy, there are concerns that the step-by-step escalation up the pyramid may not be appropriate (Baldwin & Black, 2008: 6-7). For the more serious offences, it may not be feasible to escalate up the pyramid and the more appropriate response would be to address the problem head-on at the higher levels (p.15). Yet, some firms may also become more reserved after an experience of going to court with the regulator, and

consequently, making it more difficult to get the firm to participate in more informal regulatory proceedings thereafter (Haines, 1997: 219-220).

This criticism however, is least accurate and is based on an assumption that responsive regulation is a static theory of regulation (see Picciotto, 2007; Lee, 2008). As Braithwaite so pithily pointed out in *Regulatory Capitalism*, responsive regulation is a dynamic model of regulation. It asks regulators not to be dogmatic about the theory of responsive regulation or any other theory (Braithwaite, 2010: 490). Rather, it asks regulators to "be persistently attentive to and responsive to contextual insight" (p. 490). It is not about specifying in advance which matters should be dealt with at the base of the pyramid, which are the most serious ones that should be dealt with at the middle of the pyramid and which are the more egregious ones that should be dealt with at the apex of the pyramid (Braithwaite, 2002: 30). The model sticks with the presumption that however serious the crime, it is better to start with dialogue at the base of the pyramid (p. 30). Regulators can only override the presumption to start at the base of the pyramid when there is compelling reasons to do so (p. 30). Of course, responsive regulation is not naïve either - a Madoff type executive who defrauds investors of their life savings will have to be sent off to jail, or the Dealer Member that is involved in money laundering and securities fraud will face license revocation and criminal penalties.

Perhaps a more serious criticism of responsive regulation is the practical application of the enforcement pyramid. One major point of contention to this regard is that "escalating through the layers of the pyramid may simply not happen, again because enforcement is not simply a two-actor game in which the only factor that shapes the enforcer's response is the co-operative or unco-operativeness of the regulatee" (Baldwin

& Black, 2008: 8). Indeed as Mendeloff (1993) argued, the effectiveness of responsive regulation will depend on a number of factors such as

> the resources the agency has to detect noncompliance relative to the size of the regulated population, the observability of noncompliance, the reasonableness of the standards in the eyes of the regulated community, and the penalty structure (p. 717).

There is no satisfactory answer to this criticism, simply because the problems identified are not limited to responsive regulation. Command-and-control regulation is also not a two-actor game; it requires resources and public approval; and more importantly, it does have an active audience that evaluates its enforcement activities (see Lee, 2008; Williams, 2012a). What responsive regulation does is that it fosters creative and continuous improvements in compliance strategies (Rawlings, 2007; V. Braithwaite, 2007). Dealer Members who happen to come up with flexible and creative program designs to entice compliance, and make a good case that their standards are better than the default standards, will be allowed to implement them (Braithwaite, 2012). This will ensure flexibility and cost-effectiveness by moving away from "command-and-control" strategies, while simultaneously retaining public enforcement capabilities (Healy & Braithwaite, 2006: 58; Picciotto, 2007: 14-15; Findlay, 2014: 346). The lucidity of this approach is the strength of responsive regulation (V. Braithwaite, 2007). It summons the legitimacy of both the state and corporate powers, to entice compliance. Thus, Mendeloff's (1993) criticism does not pinpoint a weakness in responsive regulation, but in command-and-control regulation where regulation either rests on the government or state power alone (also see Braithwaite, 1982: 1496-1497).

Less tangible but also very important, are the legal problems associated with responsive regulation (Freigang, 2002). The problems have to do with proportionality and

constitutionality, two components that are integral to the right for fair and equal treatment (Yeung, 2004). The very fact that different cases are dealt with differently in Ayres and Braithwaite's (1992) pyramidical model is hard to reconcile with the legal principle of equality. Not only compliance but also equality, predictability, stability etc., are among the normative pillars of the law. The adverse consequence is the law losing its legitimacy and compliance being compromised (p. 106). But this problem is overstated. Without dismissing the legal critique of responsive regulation light-heartedly, an argument can be made that within most regulatory sanction guidelines, there are mitigating factors, which must be taken into consideration in penalty imposition. Certainly, IIROC's sanction guidelines for example, award credit for cooperation, which works to mitigate against penalties imposed (see IIROC, 2009: 9-12).

As a matter of fact, the idea of responsive regulation is also figured in the "carrots-and-stick" approach that is built into the U.S Sentencing Commission Guidelines for Organizational Sanctions. Culpability scores (and thus sentence severity) for organizational defendants, may be reduced by up to three points if they have an existing internal compliance program in place. If the offending corporation lacks an internal compliance program and has more than fifty employees, the courts shall order a term of probation. The courts will only consider an internal compliance program to be effective if it is clearly specified to all employees and well integrated into the corporate culture of the organization, aptly enforced, and periodically reviewed and updated (Simpson, 2002: 101). So the lack of formalism as it applies to proportionality and consistency is not always followed, even with command-and-control regulation. If the responsive regulatory model would improve compliance, then adoption of the model can only serve to

strengthen, and not weaken the moral authority of the law (see Braithwaite, 1982: 1494-1495).

Responsive Regulation and its Accompanying Scholarship

To date, little effort has been made to empirically test whether regulatees react, and equally important, whether regulators react responsively (Nielsen, 2006: 395). Why this is so is not yet clear. One possible explanation is the lack of data (a problem not uncommon in white-collar crime research) to conduct proper parametric and non-parametric methods of data analysis. Others suggest that responsive regulation may be untestable because of its contextual mix of enforcement strategies (Rogers, 1993: 338).

Many of the earlier studies that chart the contours of responsive regulation were done by Braithwaite and his colleagues (Braithwaite, 1985; Grabosky & Braithwaite, 1986; Braithwaite & Drahos, 2000; Braithwaite, Makkai & Braithwaite, 2007). It is from these studies of different regulatory contexts that Braithwaite gained particular insights and developed the framework for responsive regulation (Kingsford-Smith, 2011: 709). From his earlier work on the coal mining industry (Braithwaite, 1985); health and safety regulation (Braithwaite & Grabowsky, 1986); and nursing home regulation (Braithwaite et al. 1994), Braithwaite and his colleagues transcend the regulatory debate and move away from command-and-control regulations, to regulations that give the employees the opportunity to be partners in the regulatory process (Findlay, 2014: 361-362). Other studies look at regulation through slightly different lenses, such as corporate crime and corporate accountability (Braithwaite, 1984, 1985); and more recently, global business regulation (Braithwaite & Drahos, 2000; Braithwaite, 2012). But it was in his highly acclaimed book titled *Regulating Aged Care* that chronicled the development of nursing

home regulation in England, the USA and Australia, that Braithwaite and his colleagues made significant strides in responsive regulation (Braithwaite et al., 2007).

In *Regulating Aged Care*, Braithwaite et al. (2007) wove together a tapestry of evidence to show that rather than using the regulatory process to assure desired quality care for the aged and vulnerable, gaming and panoptical ritualism (token compliance to appease government officials) has become center play in nursing home regulation. In response to regulatory ritualism, Braithwaite et al. (2007) advocate a new approach which proposes to balance an enforcement-based, responsive regulation pyramid with a network regulatory approach to complement each other. Responsive regulation is viewed by Braithwaite et al. (2007) as a style of regulation involving tactical negotiations between the regulator and the regulated, and the progressive ratcheting up of sanctions through a series of dialogic exchanges.

The key for understanding whether a given form of regulation or enforcement in fact qualifies as "responsive," thus requires an examination of the practices and attitudes of the regulator itself, including insights into dialogues and collaborations. It is thus not surprising that the responsive regulation literature relies heavily on interviews and other forms of qualitative research. This is true of Parker's (2006) article on the "compliance trap." It is also true of Nielsen's (2006) work, which draws not only on data gathered through agency files, but also more qualitative data furnished by questionnaires. Utilizing data from more than 2,500 legal breaches of regulatory agencies in Denmark, Nielsen (2006) was able to test whether regulators were responding responsively to misconduct by regulatees. The results showed that regulators acted responsively, but only to a small

degree and not necessarily in the responsive and tit-for-tat regulation recommended by Ayres and Braithwaite (1992).

Nielsen and Parker (2009) used data from a subsample of a survey of large Australian businesses' (i.e. businesses with more than 100 employees) that had all experienced an Australian Competition and Consumer Commission's ("ACCC") investigation into an alleged breach of the Australian *Trade Practices Act* in the previous six years. The authors found little evidence of responsive regulation occurring in practice. To the extent that responsiveness does exist, the authors found a "small amount of evidence that it has the hypothesized effects on behaviour, but not on attitudes (Pp. 376-377). That said however, there was "clearer evidence of restorative justice responsiveness having the hypothesized effects on attitudes, but not behaviour" (Pp. 376-377).

Using a combination of secondary data and interviews with 37 ACCC's staff and 21 specialist trade practices lawyers on the impact of ACCC's enforcement activity, Parker (2006) found that a regulator can improve compliance commitment with the use of responsive regulatory techniques that ''leverage'' the deterrence impact of its enforcement strategies with moral judgements (p. 591). However, when there is a lack of political support for the laws to be enforced, regulatory agencies find it difficult to regulate responsively and fall into the "compliance trap". In such scenarios, regulatory agencies face a predicament to stick to strong enforcement at the risk of facing a backlash from the business community or enforce weakly to satisfy business interests (also see Black & Baldwin, 2010).

The brief literature review of responsive regulation chronicled its development from an embryonic stage, to one where it has matured as a governance framework with

different levels of regulation. What is evident from the review is that responsive regulation has proven to be successful in environments where regulatory arrangements allows human agency to be natural and central in creating regulatory partnerships (Braithwaite, 1985; Grabosky & Braithwaite, 1986; Braithwaite & Drahos, 2000; Kingsford-Smith, 2004; Braithwaite et al., 2007; Ford, 2013). This relationship is an important indicator for responsive regulation to be possible and effective (Kingsford-Smith, 2004). However, gaps between theory and practice remain in regulatory environments where relationships are not developed to support responsive actions. This short paper cannot engage with these gaps, many of which are beyond its scope. The point here is to make an argument for responsive regulation as an enforcement strategy within an inter-agency framework in the financial sector that is reflective and emblematic of a larger contemporaneous shift from traditional market governance (see Ford 2013).

The Proposed Responsive Regulation Framework for IIROC

Responsive regulation takes into account the jurisdictional scope of the agencies responsible for regulating the regulatees (Black & Baldwin, 2010; Ford, 2013). Given Canada's inter-agency framework, a regulatory relationship can be developed that will take the jurisdictional scope of the Commissions, IMET, and IIROC into account and develop a responsive framework that will nip non-compliance in the bud, negotiate, and persuade registrants to return to compliance (see Kindsford-Smith, 2011: 734). Because the Commissions and IMET are equipped with the legislative power to impose harsher penalties, they can act as "benign big guns" to IIROC. The principle here is to project IIROC as a regulator with invincibility and teeth that has the power to escalate sanctions to more punitive penalties for non-compliance. To break this down, a more relational

agreement is created where IIROC's enforcement duties are complemented by both the Commissions and IMET, who have the legislative power to take action on cases deemed contrary to the public interest from the SROs (Williams, 2012b: 63).

Since IIROC does not have the statutory authority to enforce criminal or quasi-criminal charges involving jail sentences, it is required to refer cases with evidence of criminality to IMET (IIROC, 2008: 1). The presence of the Commissions and IMET, projects power, i.e., can use a big stick and simultaneously, compel IIROC to "speak softly" to market participants while having a credible threat of more severe sanctions up the pyramid. So instead of cultivating an expectation that the more serious cases will be sent to the Commissions and IMET, a relational agreement is made between the latter two regulators and IIROC. Securities violation is now more streamlined. Whereas before the Commissions and IMET were bombarded with cases from IIROC, regulating responsively meant that they only received the minority of recalcitrant cases where the registrants have decided not to comply. Securities governance is hinged on a regulatory partnership that will enable IIROC to regulate by using the "carrot" to open the regulatory barn door at the base of the pyramid, and close it with the "stick" wielding "benign big guns" at the tip of the pyramid. This strategy demonstrates that even with the imperfect arsenal that IIROC has at its disposal in imposing sanctions and collecting fines, it still has the power to rule with a "big stick" when the situation arises.

For those familiar with the application of the general theory of responsive regulation, the compliance strategy is one that best reflects the behaviour of the regulatees. When applied to IIROC, the enforcement pyramid works on the basis that most market participants (i.e., individual registrants and Dealer Members) would

voluntary comply with the rules and regulations governing their conduct. Many more can be regulated by way of persuasion in the context of co-operation, i.e., IIROC compliance officers giving advice when market participants are confused of the rules, rather than imposing a penalty (see Murphy, 2004; Ford, 2011). As can be seen in Figure 2, the co-operative and compliant market participants form the majority at the base of the pyramid. These are individual registrants and Dealer Members who are willing to comply with rules and regulations governing market practices. Here the idea is for IIROC to assist market participants to comply by providing them with the tools such as seminars, guidelines, and other face-to-face services, on technical compliance matters. Investors' protection is best achieved when IIROC's compliance officers identify misconduct from the onset and deal with them proactively through dialogues with regulatees.

Kingsford-Smith (2011) and Ford's (2013) works on scalability and responsive regulation in the financial sector respectively, is instructional here. Kingsford-Smith and Ford argued that with a responsive approach, compliance strategies are designed to address harmful conduct in a timely and focused manner so as not to undermine investors' confidence in the market. Compliance is an ongoing process and allows compliance staff to engage and collaborate with market participants in order to achieve overall effectiveness. Within this purview, a responsive regulatory framework will allow IIROC's compliance officers to practice a regulatory style that is largely based on negotiation and co-operation (Ford, 2011; 2013). The aim is for IIROC to influence market participants to move at the base of the pyramid, where compliance cost is at its lowest. This is done through compliance examination, which is aimed at regulatory compliance rather than disciplinary matters and authorizes IIROC's compliance staff to

conduct reviews and analysis work to spot misconducts before they arise. In so doing, IIROC's compliance staff will not rely solely on investors' complaints to address potential problems, but take a more proactive stance to review the operational, financial and trading compliance systems of investment dealers and address potential wrongdoing before investors or the markets are harmed. This strategy will allow IIROC to focus its efforts on market participants heading to the top of the pyramid and who engage in more risky behaviour. By focusing on those who do not comply, IIROC is in a position to leverage its resource to monitor compliance and create a more even playing field for market participants, while at the same time instilling public confidence in the market.

The lower middle layer of the pyramid is occupied by market participants who wish to be compliant, but might need more persuasion to comply. It is likely however, that some individual registrants and Dealer Members within this layer consider themselves to take advantage of the "grey" areas in the law and believe that they are being compliant (within their interpretations) of the law, even though they may be aware that their views are quite contentious (Freedman, 2011; 631). Where necessary, IIROC will send reminder letters, offer record-keeping visits, make special arrangements to assist Dealer Members who are experiencing financial or technical deficiencies, or assist in any other ways it can to conciliate the problem and facilitate early resolution. The assumption is that registrants and Dealer Members are rational, autonomous, and coherent actors who will comply given the opportunity to do so (Simpson, 2002; Lee, 2008; Ford, 2013; Findlay, 2014). By offering assistance, IIROC also benefits because it can participate in regulatory design in order to implement legislation that is responsive to the needs of its members.

In the upper middle layer of the pyramid, are individual registrants and Dealer Members who are less responsive to particular compliance incentives. Where there are significant concerns about protecting the investing public, or the willingness of market participants to improve their behaviours (i.e., they do not want to comply with regulatory standards), a higher level of scrutiny and more powerful interventions in the form of investigations and inquiries are applied. Detecting non-compliance through intervention is intended to have a general deterrent effect by encouraging registrants to do the right thing and comply and deter those who do not (Ford, 2013: 13). Non-compliance is detected through analysing the books and trading activities of the Dealer Members and matching information reported to IIROC. Where possible, IIROC's compliance staff will be expected to collaborate with the Commissions, IMET and other third parties such as financial institutions, to obtain relevant information. The information will then be analysed to identify discrepancies and transgressions of IIROC's rules and regulations governing its members. In cases where non-compliance is detected, registrants will be given an opportunity (within a reasonable time frame) to rectify the problem.

In the minority of recalcitrant cases where the registrant refuse to comply, more punitive actions at the tip of the pyramid will be applied. Working in close collaboration with IMET and the Commissions, a range of strategies including criminal persecution will be used to deal with registrants who are involved in market abuse and other serious conduct that are against the public's interest.

Conclusion

The application of responsive regulation within an inter-agency framework is an idea that has potential, providing it is done properly and not pushed too far. Ultimately

however, the question of whether or not IIROC can be a responsive regulator hinges on a closer examination of the agency itself, its regulatory will, and its willingness to utilize its own powers and sanctions in responding to breaches and escalating charges. Additional (and in particular more qualitative) research is needed in order to truly follow through on the ideas presented in this paper. There also needs to be more scholarly work on the reflection back from the field of securities regulation to general theories of regulation, including responsive regulation. For example, what does this area and the failures that occurred in 2007/08 tell us about why people comply or do not comply and what sorts of regulatory designs will work or not work? How can we criticize or develop existing theories of regulation to take account of what has happened empirically in this field? All these questions need systematic exploration. In order to be able to design regulatory strategies in the securities industry that are able to act responsively in the manner outlined by Ayres and Braithwaite (1992), there needs to be new immediacy on research that examines the unresolved questions outlined above.

NOTES

[1] In 2013, the Canadian government joined with Ontario and B.C.to create the Cooperative Capital Markets Regulators (CCMR). For the other provinces and territories, most notably Quebec and Alberta, this remains a tough sell.

[2] In April of 2013, the FSA was split into two separate regulatory authorities - the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA).

[3] Ironically, the original role of the criminal justice system was not to dominate, but was seen as an institution that would instill discipline and good social qualities in the offender. Michel Foucault, in his book *Discipline and Punish: The Birth of the Prison* (1975) gives a good account of this issue.

[4] Unless otherwise stated, this article uses the terms "investors" and "clients" interchangeably to generally mean an individual that is conducting business with a particular broker and Dealer Member.

[5] The CSA is the umbrella organization made up of the 10 provincial and 3 territorial securities regulators in Canada. In the absence of a national regulator, the CSA is responsible for developing a harmonized approach to securities regulation across Canada.

[6]Scholz's (1984) models regulation as a prisoner's dilemma game, where the motivation of the firm is to minimize regulatory cost while the motivation of the regulator is to maximize compliance outcomes. Under this model, it is assumed that there is equal power between the regulators and the firms that they seek to regulate. TFT means that the regulator refrains from a deterrence response once the firm is cooperating; when the firm cheats on compliance, the regulator shifts from a cooperative to a more deterrent oriented response. The optimal strategy is for the firm and regulator to cooperate until one or the other defects from

cooperation. The rational player will then retaliate (the State to deterrence; the firm to a law evasion strategy). If the retaliation secures a return to cooperation by the other player, then the retaliator would be forgiven and this would restore the benefits of mutual cooperation in place of the lower payoffs of mutual defection (See Ayres & Braithwaite, 1992: 20-23).

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