

Problem-Oriented Policing Approaches to Securities Fraud

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*The views expressed herein are those of the authors and do not
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Abstract

This guide outlines a problem-oriented approach to securities fraud. Because problem-oriented policing may not be familiar to some of those responsible for dealing with securities fraud, we first explain this approach to crime reduction. We then outline the problem of securities fraud and consider the involvement of organized crime in this offense. In the rest of the guide, we take a more detailed look at securities fraud, consider the factors contributing to securities fraud in Canada, and describe a number of possible ways of applying a problem-oriented approach to this problem.

Executive Summary

Problem-Oriented Policing and Securities Fraud

This guide outlines a problem-oriented approach to securities fraud. Because problem-oriented policing may not be familiar to some of those responsible for dealing with securities fraud, we first explain this approach to crime reduction. We then outline the problem of securities fraud and consider the involvement of organized crime in this offense. In the rest of the guide, we take a more detailed look at securities fraud, consider the factors contributing to securities fraud in Canada, and describe a number of possible ways of applying a problem-oriented approach to this problem.

Problem-oriented policing (POP) is a broad philosophical approach that represents a systemic change in the way police departments approach their mission. Rather than simply looking at individual events or cases, POP combines these cases into discrete ‘problems’ and then develops strategies to deal with the factors underlying these problems. In concrete terms, rather than just responding to 911 calls, each treated as a unique event, the police should identify the patterns underlying these calls and develop solutions to them. These solutions will ideally reduce the incidence of crime and victimization rather than just providing a response after a crime has taken place. Problem-oriented policing follows a systematic planning process that involves four major steps: identifying and analyzing crime problems; developing a response to these problems; implementing this response; and monitoring and evaluating the program.

When applied to securities fraud, a POP approach would emphasize a greater focus on proactive solutions that can prevent frauds from occurring in the first place, thus avoiding losses by investors. Central to this proactive, problem-oriented strategy would be the implementation of preventative measures that operate outside the criminal justice system. This process begins with a greater understanding of the scope, causes, and aggravating factors of securities fraud. A POP approach would likely mean a greater education of investors; an increase in the quantity and quality of market regulation; an emphasis on

intelligence gathering and intelligence-led policing and regulation; a greater cooperation between police, regulatory agencies, the private sector, and consumer advocacy groups; mandatory ethics training for industry professionals; and retributive measures for offenders that complement or even operate outside the criminal justice system with the goal providing restitution for victims.

The Problem of Securities Fraud

Securities fraud, also known as stock market or investment fraud, has become a major concern in recent years. There are no accurate estimates of the extent of securities fraud because violations are not well reported and because enforcement is lax. However, there have been a rash of high-profile fraud cases in North America in recent years including the corporate scandals of Bre-X and Enron and the Ponzi schemes run by Bernard Madoff and Earl Jones. These cases have highlighted the enormous consequences of securities fraud.

Organized crime is involved in securities fraud. The growing sophistication of organized crime is exemplified by its infiltration of the capital markets, which has evolved from the physical theft of security certificates in the 1950s to technology-assisted fraud and money laundering. At the same time, criminal groups continue to rely on traditional tactics such as intimidation, violence, and corruption to advance their interests in the securities market. Organized crime has infiltrated the capital markets for two reasons. The first is to make money, primarily through fraud, share manipulation, insider trading, as well as deceitful and coercive telemarketing. The second reason is to launder money generated from drug trafficking and other profit-oriented crimes.

There are many different types of securities fraud. Among these are: insider trading, manipulation of share prices through corporate misstatements and omissions, pump and dump schemes, and high closing ; and illegal sales practices such as Ponzi schemes, illegal distributions, forex scams, investment seminar scams and misconduct by registrants, embezzlement of investor's funds, and front running.

Offenders, Victims, and Contributing Factors

One of the keys to effective problem-oriented policing is knowledge of the characteristics of offenders and victims. Unfortunately our knowledge of securities fraud victims and offenders is much more limited than our knowledge of most other types of serious crimes.

There are several very different types of offenders – corporate executives who misrepresent their company's profits have very different characteristics than serial 'pump and dump' offenders who move from one scam to another. The limited research that is available indicates that securities fraud offenders were white, relatively well-educated males who specialized in white-collar offenses. Securities fraud offenders had higher rates of recidivism than other 'high-status' white-collar crime offenders. Recidivists tended to move from place to place while developing new fraudulent schemes. Offenders who committed securities fraud were intelligent, had business savvy and strong interpersonal skills, lacked empathy, and were able to rationalize their misconduct. A small-scale study of fraudulent hedge funds found that several of the principals were predatory recidivists who lied about their backgrounds and qualifications.

Other than knowing that large frauds such as Enron victimize a broad range of people through their impact on pension funds and other investments, we know even less about victims than about offenders. The limited evidence there is suggests that seniors may be disproportionately victimized by some types of fraud and that some people may be repeatedly victimized. One study of Ponzi scheme victims showed that most victims were well-educated and employed and that victims recruited others (often people from the same company) to the schemes.

The paper also identifies some of the factors that contribute to securities fraud. These factors include: performance pressures on managers and workers; corporate compensation systems that reward short-term performance; investment practices such as marketing hedge funds through independent investment consulting firms; the

development of new types of investments such as hedge funds and derivatives that are difficult for investors and regulators to understand; new technologies such as the Internet that provide opportunities for fraud; the increasing vulnerability of victims; the underreporting of securities fraud ; and the low risk of sanctions for offenders.

Possible Measures to Reduce Securities Fraud

A number of measures have been put in place at the industry, regulatory, and criminal enforcement levels in Canada to prevent securities fraud from occurring. These preventive measures can be divided into three categories: (1) fundamental components of securities regulation (2) education, and empowerment of investors and (3) intelligence-based regulatory and enforcement initiatives (e.g. market surveillance). However, despite these measures, more needs to be done to reduce the incidence of securities fraud. Some of the possible ways of utilizing problem-oriented policing to do this are discussed in the paper. These include:

- Improved investor education. A comprehensive nation-wide communication/education strategy must be developed. This campaign must rival that of the fraudsters. Innovative ways must be found to reach the public and greater resources must be invested in education.
- Intelligence-led policing. Information gathered through market surveillance, other intelligence sources and investigations can be used as a basis for awareness-raising and educational campaigns for investors and the development of rules, policies and programs designed to address the fraud problems that have been identified.
- Mandatory ethics training for securities industry participants. Ethics courses and other training should be a part of MBA programs, other certification accreditation bodies (securities trader, financial advisor, etc.), and part of company training programs. Beyond simply training people in ethics,

company officers should be obliged to ensure that an ethical culture prevails within their organizations.

- Increasing the role of non-state actors. A broad range of non-state actors can potentially be involved in preventing and controlling securities fraud, including the financial services industry (e.g., the IIROC), the private policing and forensic accounting industries, and private citizens in their capacities as consumers and retail investors. As the financial services industry is already an active player in the regulation of the markets, this section deals primarily with private citizens and the private policing and forensic accounting sector and suggests that multi-agency partnerships are most likely to be effective.

Finally, the report suggests that the government work with the securities industry, government regulators and researchers to develop a research program that would provide some of the basic information required for implementing a successful problem-oriented approach to securities fraud.

This guide outlines a problem-oriented approach to securities fraud. Because problem-oriented policing may not be familiar to some of those responsible for dealing with securities fraud, we first explain this approach to crime reduction. We then outline the problem of securities fraud and consider the involvement of organized crime in this offense. In the rest of the guide, we take a more detailed look at securities fraud, consider the factors contributing to securities fraud in Canada, and describe a number of possible ways of applying a problem-oriented approach to this problem.

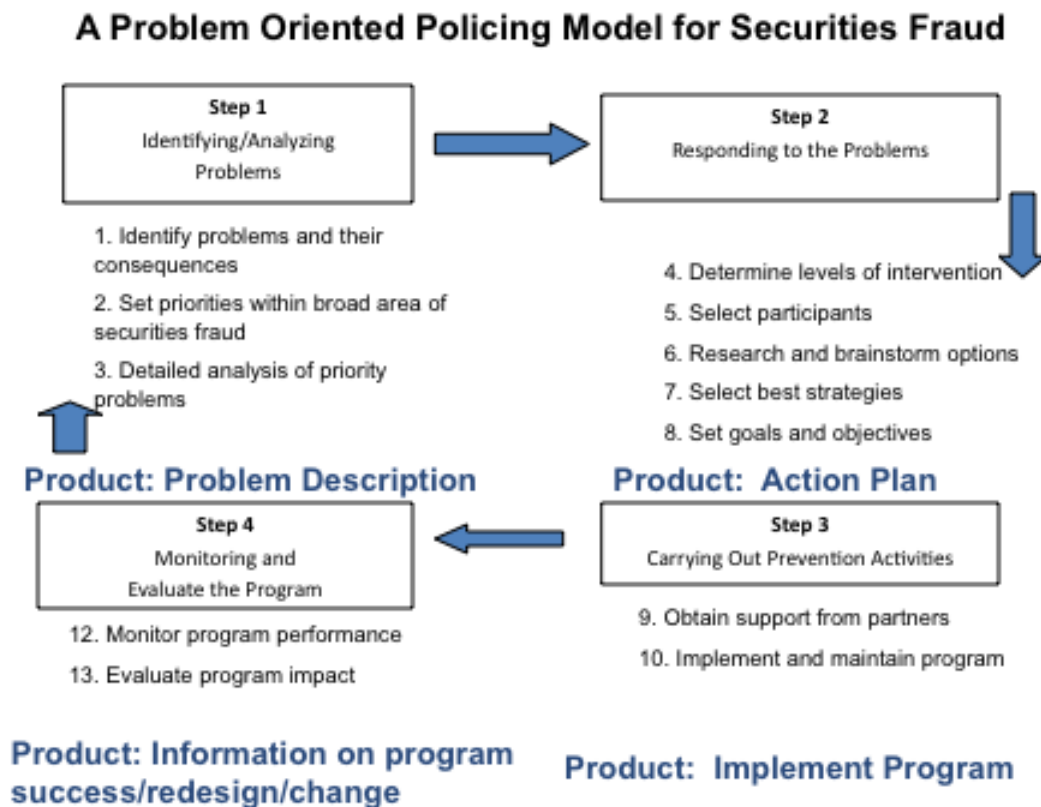
What is Problem-Oriented Policing?

Traditionally, the police have been a reactive organization, as most of their workload is generated by calls for service. Critics of this approach have argued that rather than waiting until after a crime has been committed, the police need to be proactive and try to address the factors that generate criminal activity. Herman Goldstein was the first to articulate the philosophy of **problem-oriented policing**:

Problem-oriented policing is an approach in which discrete pieces of police business (each consisting of a cluster of similar incidents) are subject to microscopic examination (drawing on the skills of crime analysts and the accumulated experience of operating field personnel) in hopes that what is freshly learned about each problem will lead to discovering a new and more effective strategy for dealing with it. Problem-oriented policing places a high value on new responses that are preventive in nature, that are not dependent on the use of the criminal justice system, and that engage other public agencies, the community and the private sector when their involvement has the potential for significantly contributing to the reduction of the problem. Problem-oriented policing carries a commitment to implementing the new strategy, rigorously evaluating its effectiveness, and, subsequently, reporting the results in ways that will benefit other police agencies ... (Goldstein, 2001).

For Goldstein, problem-oriented policing (POP) was a broad philosophical approach that represented a systemic change in the way in which police departments approached their mission. Rather than simply looking at individual events or cases, police would combine these cases into discrete ‘problems’ and then develop strategies to deal with the factors underlying these problems. In concrete terms, rather than just responding to 911 calls, each treated as a unique event, the police should identify the patterns underlying these calls and develop solutions to them. These solutions would ideally reduce the incidence of crime and victimization rather than just responding after a crime has taken place.

Figure 1 illustrates the steps involved in the problem-oriented policing process.



Step 1. Identifying/Analyzing Problems – Problem-oriented policing relies on detailed knowledge of the problem in order to develop the best solutions. Just as doctors must diagnose their patients before treating them, those interested in

preventing crime need to know as much as possible about the patterns of the offense as well as about the offenders and the victims.

The first task is set priorities. There are many different types of securities frauds and diverse groups of offenders and victims. There will always be resource limitations, so those planning to deal with securities fraud will have to set priorities. While this can sometimes be a difficult process, it is a necessary step, because concentrating resources where they are most needed is the only way to be successful in reducing crime. In order to establish priorities, planners need to learn as much as possible about these problems. The extent of this initial problem analysis will depend upon the availability of resources. Ideally, planners will draw on as broad a range of information as possible including data concerning victim characteristics, offender characteristics, location, distinctive offense patterns, and any opportunity factors that might be facilitating the offenses. There are many possible sources of information about securities fraud, including police statistics, data collected by regulatory agencies, media reports, and public surveys. Since this is a very complex and technical area, available data should be supplemented by interviews with experts in the securities field and with offenders. If resource constraints limit the analysis that can be done at the beginning of the planning process, it will be essential to conduct this detailed analysis once priority problems have been identified,

In addition to learning as much as possible about the problem, planners should also understand the interests involved and should understand and critically assess the way their agencies now deal with it (Scott, 2000).

Once the problem has been identified and analyzed, the next stage in the process is to develop a comprehensive response to that problem.

Step 2. Responding to the Problems

Determining the most effective response can be a complicated process because the best solutions to complex problems like securities fraud are multi-faceted and involve many different partners.

The first three tasks in this step are often done simultaneously or through an iterative process. The first of these tasks involves determining the appropriate level (or levels) of intervention. For example, should the securities fraud be addressed at the federal level through legislation, at the provincial level through securities regulation, or at the local level through educational campaigns run by local police and the securities industry? Or will all three levels need to become involved? Second, participants need to be selected to work on the planning process. This step is important because comprehensive strategies require a diverse group of partners and all should be involved as early as possible in the planning process. Third, once participants have been identified, they should be given the problem analysis and asked to review and to refine it and to help develop effective solutions. The research literature should also be reviewed to ensure that the solutions that are eventually adopted are evidence-based to the greatest possible degree¹.

Planners should consider the factors that cause or facilitate this crime, as these causes and facilitators can be targeted for intervention. For example, Cressey developed the idea of the securities fraud triangle (Figure 2). He believed that securities fraud would be most likely to occur where there were incentives (or pressures), opportunity, and rationalization. This triangle can help suggest possible solutions. For example, we might reduce the incentives or pressures to break the law by changing executive compensation systems to reward long-term profit growth rather than short-term increases in stock prices. Opportunity might be reduced by educating potential investors about Ponzi schemes or by developing partnerships with forensic auditors. Ethics programs and enhancing a

¹ This process is often iterative because the planning group may identify strategies that require the involvement of additional participants who may work at different intervention levels.

‘compliance culture’ within corporations may help to reduce the ability of executives to rationalize breaking the law.

Figure 3 shows a similar triangle that is frequently used to help develop POP solutions. This triangle leads us to think of strategies that focus on making victims less vulnerable or crimes less rewarding; reducing the motivation of offenders or their ability to commit their crimes; or by making changes at the place where crimes occur (stock exchanges, the Internet, etc).

While we are considering **what** to do, we will also consider **whom** we need to work with to implement our selected strategies.

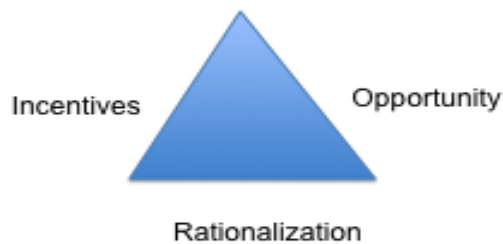


Figure 2
The Fraud Triangle



Figure 3
The Crime Triangle

The final tasks in this step are to select the best strategies from those developed by the planning group and to set goals and objectives to guide implementation.

Step 3. Carrying Out Prevention Activities

This step involves working with partners to implement and to maintain the program. Securities frauds can be extremely complex crimes and can involve many different people working in several different countries. Because the profits can be huge, those committing fraud can pay for experts to help them conceal their crimes. Thus enforcement efforts require a great deal of teamwork. Planners need to determine the most appropriate individuals and institutions to deliver the proposed interventions.

The police cannot deal with securities fraud by themselves. Investigating securities fraud can be extremely expensive and time-consuming and few police have the skills needed to do these investigations. Various regulatory agencies have the authority and the resources to carry out enforcement activities and non-police agencies may be best placed to run prevention programs in this area.

Step 4. Monitoring and Evaluating the Program

The final step involves monitoring the implementation of the program and evaluating its outcome. Program monitoring is important because many crime reduction programs are poorly implemented. Some of the reasons for implementation failure are resource issues, lack of cooperation by partners, and a lack of commitment on the part of some of those involved.

It is also important to evaluate outcomes in order to ensure that the program is effective. Law enforcement and regulatory agencies often measure their performance with measures of **output** rather than measures of **outcome**². Output measures are useful, but only as part of a more comprehensive evaluation strategy that ultimately looks at program impact.

² Output refers to factors such as the number of files opened and the number of investigative hours spent on these files. Outcome refers to factors such as the level of securities fraud and number of convictions.

Evaluation is not necessarily the end of the planning process. If the evaluation shows that desired outcomes are not being achieved or that there are flaws in the program, the planning cycle can begin again grounded in these results. Many successful crime reduction initiatives have initially met with limited success and had to go through the planning cycle several times.

When applied to securities fraud, a POP approach would emphasize a greater focus on proactive solutions that can prevent frauds from occurring in the first place, thus avoiding losses by investors. Central to this proactive, problem-oriented strategy would be the implementation of preventative measures that operate outside the criminal justice system. This process begins with a greater understanding of the scope, causes, and aggravating factors of securities fraud (see Figures 2 and 3). A POP approach would likely mean a greater education of investors; an increase in the quantity and quality of market regulation; an emphasis on intelligence gathering and intelligence-led policing and regulation; greater cooperation between police, regulatory agencies, the private sector, and consumer advocacy groups; mandatory ethics training for industry professionals; and retributive measures for offenders that complement or even operate outside the criminal justice system with the goal providing restitution for victims.

Typically, problem-oriented policing frameworks have been applied to street crime rather than to white-collar crime and as a result we know far less about white-collar offenses than about street crimes. For example, we know with a relatively high degree of accuracy how many homicides there are and how many cars have been stolen. We can draw upon police statistics and victimization surveys to estimate the number of burglaries, assaults and robberies. However, we have no way of knowing how much money is lost in securities frauds. There are also many studies looking at the causes of different crimes and many of these studies are based on interviews with offenders. Very few researchers have applied a similar methodology to the study of securities fraud.

The Problem of Securities Fraud

Securities fraud, also known as stock market or investment fraud, has become a major concern in recent years. There are no accurate estimates of the extent of securities fraud³ because violations are not well reported and because enforcement has been limited. However, there have been a rash of high-profile fraud cases in North America in recent years including the corporate scandals of Bre-X and Enron and the Ponzi schemes run by Bernard Madoff and Earl Jones. These cases have highlighted the enormous consequences of securities fraud. Companies went bankrupt, thousands of employees lost their jobs, shareholders (including many pension plans) lost their investments, and many individuals were defrauded out of their life's savings. Securities fraud is also attractive to organized criminals, who use it both to make illegal money and as a means of laundering money generated through their other criminal activities.

Securities fraud is a criminal and/or regulatory offence involving deceptive practices in the stock and commodities markets⁴. While there are many types of securities frauds, one of the most common forms involves manipulating the price of publicly traded stocks or bonds to take unlawful advantage of investors. This is done primarily by the intentional concealment, omission, misrepresentation, or distortion of public information, including misstatements on a public company's financial reports, and through "pump and dump" schemes.

Fraudulent schemes committed in the securities and commodities markets can contribute to instability in the markets (and in the financial services sector and economy as a whole) and a loss of confidence by investors in these markets. Of course, securities fraud can have a devastating impact on victims, as evidenced by recent high profile cases involving Bernard Madoff and Earl Jones in the U.S. and Canada.

³ The Canadian Centre for Justice Statistics is expected to release some baseline data on fraud victimization which will be very helpful in planning prevention programs.

⁴ The broad range of securities fraud is one of the reasons why priority setting is such an important part of problem-oriented policing. With limited resources, it will only be possible to focus on particular types of problems, victims, and/or offenders.

The extent of securities fraud in terms of illegal acts, number of investors affected, and the amount of money lost has increased as the capital markets have grown and as the Internet has emerged to facilitate criminal opportunities.

Organized Crime and Securities Fraud

Organized crime now involves financially shrewd and technologically astute multinational conglomerates and networks which have shown a capacity to adapt to enforcement successes by developing new strategies and tactics. The growing sophistication of organized crime is exemplified by its infiltration of the capital markets, which has evolved from the physical theft of security certificates in the 1950s to sophisticated technology-assisted fraud and money laundering schemes. At the same time, criminal groups continue to rely on traditional tactics such as intimidation, violence, and corruption to advance their interests in the securities market. Organized crime has infiltrated the capital markets for two reasons. The first is to make money, primarily through fraud, share manipulation, insider trading, as well as deceitful and coercive telemarketing. The second reason is to launder money generated from drug trafficking and other profit-oriented crimes.

From the 1950s to the early 1970s, traditional crime groups in the United States and Canada masterminded schemes to steal millions of dollars worth of securities certificates from the vaults of brokerage houses and banks (Philips, 1963: 72; Walter 1971; Edwards, 1990: 39). To facilitate these thefts, criminal groups relied on corruption and intimidation of industry insiders.

The move into fraud was illustrated by the activities of William Obront, the financial brains behind Montreal's once-powerful Cotroni mafia family, who was charged with over 400 counts of fraudulently manipulating stock market shares over a 15-year period (Quebec Police Commission Inquiry on Organized Crime, 1977: 148). A 1974 intelligence report on commercial crime by the Coordinated Law Enforcement Unit (CLEU) of British Columbia documented the involvement of organized (and

unorganized) criminals in the Vancouver Stock Exchange. In 1997, police began investigating the possible role of outlaw motorcycle gang members in manipulating the publicly traded stock of Montreal-based BioChem Pharma. This case illustrated how organized criminals use their traditional tactics to influence securities markets. The investigation was intensified after four bombs exploded outside the company's Quebec headquarters on November 24 and 25 of that year (*Financial Post*, 1997). One media article reported that over those two days, an unusually large number of BioChem "put options" was purchased through the Montreal Exchange. The intent of the bombings may have been to destabilize the stock, causing it to drop rapidly and allowing speculators to make a substantial profit (*Financial Post*, 1998).

In 2002, the Ontario Securities Commission acknowledged that organized crime was active in the capital markets across Canada, through money laundering, manipulating share prices, and conducting insider trades (*National Post*, 2002). The OSC's recognition of the involvement of criminal groups in Canada's stock markets was not new; in 1999 it called for a formal partnership between itself and the RCMP in part to crack down on "a disturbing growth in crime in the securities industry, crimes to which a very large degree have been committed by organized syndication" (*Globe and Mail*, 1999). In one of the most recent cases, an alleged member of the Comisso crime family has recently been charged for his participation in a 'pump and dump' scheme involving a company called Pender International (Van Alphen, 2007).

Organized crime was doing the same thing in other countries, including the United States. By the late-1990s, U.S. federal law enforcement agencies and securities regulators began investigating allegations that members of Italian-American crime families, in cooperation with Russian crime groups, had established a network of stock promoters, securities dealers, brokerage firms, and "boiler rooms" that sold stocks nationwide through high-pressure sales tactics and intimidation. In 1996, *Business Week* reported that Philip Abramo, a ranking member in the New Jersey-based DeCavalcante crime family, controlled at least four brokerage firms through front men and exerted influence upon still other investment dealers. Other securities dealers and traders were reported to have paid

extortion money or “tribute” to Abramo (*Business Week*, 1996: 92-93). In 1999, federal prosecutors brought indictments against 85 people, including brokers and suspected members and associates of the DeCavalcante organization as well as New York’s Colombo, Bonanno, and Genovese crime families. The indictments alleged the defendants stole more than \$100 million from investors using threats, bribes, pension fund raids, and “pump and dump” market manipulation tactics. The conspirators secretly controlled large blocks of shares in approximately 20 micro-cap companies which they pushed onto investors through high-pressure sales calls. They also paid their own brokers hefty kickbacks to pressure outside investors to buy shares at inflated prices. Mafia enforcers were employed to ensure none of the brokers would sell on behalf of their clients, thereby keeping the price of the stocks artificially high. Once the stock value peaked, the conspirators sold their secretly held shares (*Knight Ridder/Tribune Business News*, 1999; *The Globe and Mail*, 1999; *Dow Jones News Service*, 1999; *Associated Press*, 2000).

Money Laundering

Organized crime is also interested in using the capital markets to launder the profits of other criminal activities, in particular drug trafficking. Police cases demonstrate that any profits generated from traditional securities-related illegalities, such as insider trading or market manipulation, will in turn be laundered through securities investments:

The principals of a publicly listed company were involved in the fraudulent manipulation of stock as well as theft and fraud of the company’s assets and treasury. The proceeds from the manipulation, which were realized as funds located in trading accounts indirectly controlled by the principals, were seldom paid out to the principals by the brokerage firms. Instead the funds would be converted to investments into different companies, including ones involved in movie production, medical technology and brokerage firms. Further investigated revealed that these companies were in turn headed by the same people who manipulated the price of the securities. (Beare and Schneider, 1990:190).

Cases reveal that mechanisms that facilitate securities infractions, such as the involvement of tax haven countries, the use of nominee accounts and shell companies, the involvement of lawyers and banking institutions and a diverse range of securities are also conducive to the laundering of the proceeds of organized crime.

In a 2004 study examining RCMP cases involving the laundering of proceeds of crime through the legitimate Canadian economy, Schneider (2004; 2005) found that revenue from drug trafficking or other organized crime offences can enter the securities market in a number of forms: as cash, monetary instruments, and account transfers.

Criminals laundering money through the securities market will more typically gain access through a brokerage firm. A brokerage firm has advantages for money laundering because of its position as a chief point of entry into the stock market for investors and also its ability to operate as a quasi-deposit taking institution, whereby funds can be converted into account credits, securities, or monetary instruments. Brokerage firms can also be used to electronically transfer funds between accounts and between countries.

A report on money laundering typologies highlights the use of derivatives to launder the proceeds of crime. “Compared to banks,” states the report, “the derivatives markets and associated products represent perhaps a better opportunity for laundering because of the ease with which audit trails can be obscured.” The high volume of trading activity and a high degree of liquidity of the derivatives market, combined with the numerous brokers who trade the products, muddies the connection between each new participant and the original trade. As a result, “no single link in the series of transactions will likely know the identity of the person beyond the one with whom he is directly dealing”(Financial Action Task Force, 1999: 13).

Instead of purchasing securities, a criminal enterprise may take the opposite route to launder their illicit proceeds by offering shares in a public company, previously injected with criminal proceeds. This gives a criminal organization the opportunity to raise

capital and thus a seemingly legitimate source of funds. Under this method, a private company is incorporated or an existing one is bought by a criminal organization. The registered owners, directors, and officers of the company are nominees, such as a lawyer or an offshore shell company. The company may not carry out any legitimate business, but can appear to be highly profitable through the injections of the proceeds of crime, which are made to appear as the legitimate revenue. Shares are then issued to the public in conjunction with a respectable underwriter. The actual laundering occurs after shares are purchased and the original criminal owners of the company receive the “capital financing”. The objective of this method is to generate a clean dollar through the issuing of shares for every dirty dollar invested in the company before its initial public offering. Because these shell companies can appear to be highly profitable through the injection of criminal profits, the original investors can actually make a substantial profit on their investment through the initial public offering.

The Canadian case of YBM Magnex is an example of this type of transaction. A major Russian organized crime figure, Semyon Mogilevich, was one of the people behind the company. In 1999, YBM officers pleaded guilty to conspiracy charges in U.S. Federal Court, admitting the company was conceived as a vehicle for fraud and money laundering. The company eventually went bankrupt, costing shareholders hundreds of millions of dollars. According to court documents filed by U.S. Government attorneys, Mogilevich intentionally used Canadian stock exchanges to orchestrate his laundering activity because he felt Canada has lax regulations. According to Assistant U.S. Attorney Suzanne Ercole “One of the concepts behind the [money laundering] plan, and the formulation of the plans to take [YBM] and make it a public company and to initiate trading, was to initiate trading on the exchanges in Canada” because they believed that the regulations were more lenient (*Globe and Mail*, 1999).

International Transactions and Safe Haven Countries

The ongoing internationalization of securities markets parallels the increased transborder movements of illicit money for purposes of laundering. Sophisticated laundering

techniques take advantage of the integration of the world's securities community by conducting transactions that cross national borders and by using safe haven countries to obstruct any paper trail. The first step in many international laundering operations will be to send the illegal funds offshore, often to a safe haven country with strong bank secrecy laws. Police cases demonstrate a persistent connection between Canada and such safe haven countries in the laundering of illicit proceeds generated from securities infractions and other criminal offences.

There is a growing concern about the new possibilities for fraud and money laundering offered by electronic commerce, trading online and Internet banking. Criminals can launder illicit revenues through e-commerce transactions, sending electronic cash to cyber-accounts located all over the world which then reappear as stocks and shares. The Internet provides anonymity and facilitates international transactions, which are so critical to fraud and money laundering. Some of the most sophisticated criminal organizations have the financial resources to buy technology and expertise that can match or exceed the efforts of enforcement agencies.

Types of Securities Fraud⁵

Insider Trading

Insider trading involves trading securities using non-public information about a company that can affect the value of that company's securities. The insider is typically (though not always) an employee, director, or officer of the company who has access to this information before it is made public. Profit is made at the expense of those who did not have the inside information. Serious cases like Enron and WorldCom involved senior executives in these companies who knew that their companies were in serious financial difficulty, but who reassured the public that all was well while selling their own shares for peak prices. Insider trading can also occur at a smaller scale. One of the cases

⁵ The list of securities fraud included in this section is not exhaustive, but encompasses the most common types of fraud.

recently resolved by the Alberta Securities Commission involved an individual who used inside information gained as an IT support analyst with TD Securities to gain \$118,000 in profit (Canadian Securities Administrators, 2009).

Manipulation of Share Prices

Corporate Misstatements and Omissions

In recent years there have been many high-profile cases where companies have tried to artificially inflate or maintain the value of their stock by over-stating the value of assets, revenues, sales, profits, etc. Former senior Livent officials Garth Drabinsky and Myron Gottlieb were recently found guilty of fraud and forgery for overstating the company's profits and understating its costs in order to keep its stock price high. CV Technologies, makers of Cold-FX, were found to have breached disclosure regulations by wrongly recognizing revenues, and the company and its officers were required to pay \$740,000 in settlements and costs (Canadian Securities Administrators, 2009).

Pump and Dump

In a "pump and dump" scheme, attempts are made to artificially inflate the price of a stock ("the pump"). This is accomplished by intensive promotion of the stock, often through misleading or outright false information, which leads to increased trading in the stock, which in turn leads to a higher value. Once the price hits a peak, those behind the scam sell off their shares (the dump") before the real value of the company is known by other investors. According to Picard, the market for penny stocks facilitates these schemes because "The insufficient reporting requirements, the lack of regulation and the absence of control and supervision make it a jungle in which criminal organizations operate at will (2008: 390)". These schemes to defraud investors do not require a great deal of expertise or a high level of organization.

High Closing

To artificially inflate the value of a mutual fund at the end of a year or quarter, fund managers have purchased stocks at a higher than market value just as the market closes. While the stock will usually decline in value the next day, the closing price is used to calculate the value of the fund. In 2000, RT Capital, a branch of the Royal Bank of Canada, admitted to using high closing to manipulate the value of 26 stocks held by its funds.

Hedge Fund Valuation Fraud

The value of an investment is critically important to an investor because the value is the measure of how well an investment has performed over time and of the amount of funds they have available. Because of their complexity, hedge funds can often be difficult to value. Hedge fund managers have incentives to over-value their funds, so there have been cases of fraudulent valuations (Haskin et al, 2009).

Illegal Sales Practices

Ponzi Schemes

Ponzi schemes have been around for many decades, but have become well known in recent years because of the serious frauds committed by Bernie Madoff and Earl Jones. In a ponzi or pyramid scheme (Evola and O’Grady, 2009), investors are solicited through the prospect of high returns on investments. Investors are initially paid returns, “interest cheques” or dividends on their investments. However, the funds paid out are not generated from actual investments. Indeed, the money is generally not invested. Instead, payouts to clients are from the contributions of new investors. That is why the “returns” to investors are often quite high, in order to attract more investors to generate investment funding that can be spent by the organizers and/or paid out to investors. Eventually the new money runs out and the scheme collapses.

Illegal Distributions

The most common securities law violations dealt with by the Canadian Securities Administrators (CSA) are illegal distributions (Canadian Securities Administrators, 2009). These violations make up about half of the CSA's caseload and involve distributing securities without registration or a prospectus. Some of these cases involve Ponzi schemes while others involve 'boiler rooms' established to market worthless stock to the public through aggressive telemarketing.

Forex Scams

These frauds typically involve software or training courses that will help investors make money in the foreign exchange (forex) market. In some cases the investor's money is stolen by those running the fraud. Even where the fraud is not this overt, the investor is not told that foreign exchange investments are very risky and there is a high likelihood that money will be lost (Canadian Security Administrators, 2010).

Investment Seminar Scams

Investment seminars often promote one or more of a variety of tax shelters. In many cases these tax breaks are actually frauds and investors end up owing money and penalties to the Canada Revenue Agency (Canadian Security Administrators, 2010).

Misconduct by Registrants

Employees of several large brokerage firms have engaged in fraud by committing acts such as churning accounts (frequent trading done on accounts in order to generate commissions for the broker), lying to clients about risk, and failing to supervise employees. In 2009 the Canadian Securities Administrators fined several institutions, including National Bank Financial, Scotia Capital, CIBC and CIBC World Markets,

Laurentian Bank Securities, and Canaccord Financial, a total of \$138.8 million for failing to disclose to their clients some developments concerning third-party asset-backed commercial paper. In the same year National Bank Financial was fined for failing to adequately supervise an adviser who pursued investments that were riskier than the client's risk tolerance required. (Canadian Securities Administrators, 2009).

Embezzlement of Investors' Funds

In some cases, investors' money has simply been stolen by those responsible for investing it safely. Vincent Lacroix, the founder of Norbourg Financial Group is currently serving a five-year jail term for taking \$130 million that investors had invested with his firm. Lacroix transferred the money into his own accounts and falsified company reports. Over 9,000 people were victimized by Lacroix.

Front Running

If a broker receives a large buy or sell order from a client, before executing that order the broker may buy or sell that stock on his or her own account before placing the order. This allows the broker to take advantage of any increase or decline in the stock price that results from the client's order.

Offender Characteristics

In developing crime prevention strategies it is important to know as much as possible about offenders, as many types of prevention programs must be targeted at specific types of offenders. For example, a city that faced an auto theft problem because of adolescent joyriders would use different types of crime reduction strategies than one where most auto thefts were committed by adults who were shipping the cars offshore. On the other hand, some strategies such as vehicle immobilizers could be effective against both types of offenders.

There are distinct patterns of securities frauds and these reflect different types of offenders. For example, Garth Drabinsky, the former CEO of Livent who was recently convicted of falsifying financial records, has little in common with Semion Mogilevich, the Russian organized crime figure behind the YBM Magnex scandal or with Michael Lee Mitton who set up the Pender International fraud. Also, when we look at individuals within legitimate organizations, we see that some offenders are ‘opportunity seekers’ who actively search out opportunities to commit securities fraud. Others are ‘opportunity takers’ who take advantage of opportunities presented to them or who succumb to corporate pressures to commit fraud. To some degree these different offender patterns imply that different solutions will be necessary. The enhanced ethics programs and corporate oversight that might prevent opportunity takers from committing fraud would do little for the predator who sets up a boiler room or Internet site to convince people to invest in a fraudulent stock or the organized criminal who is using a brokerage to launder drug money.

While there are many journalistic accounts of large-scale securities frauds, little research has been done on people who commit securities fraud, let alone research on the different types of securities fraud offenders. While this limits our ability to understand the background and motivations of securities fraud offenders, there is some research that at least provides some information that can be used to help generate prevention strategies.

Wiesburd et al (2001) looked at a broad sample of white-collar crime offenders and found that while securities fraud offenders had lower than average rates of recidivism, their recidivism was high compared with other ‘high status’⁶ white-collar offenses such as antitrust violation and bribery. Also, about 25 percent had committed other offenses before their first securities fraud charge. They tended to specialize in white-collar offenses rather than committing other categories of offenses. The sample was almost all white males. Eighty percent were married and 39 percent had at least a college degree.

⁶ Low status offenses include offenses such as false claims, credit fraud and mail fraud. These offenses had recidivism rates that were considerably higher (62% for each of these 3 offenses) than for securities fraud (37%).

Barnard (2008) has reviewed some of the research on the characteristics of securities fraud recidivists. She found that there was a high rate of recidivism – one study she cited found that 25 percent of securities fraud violators in Florida had previous actions against them for fraud or economic crime⁷. Among recidivists, there was a pattern of moving from place to place and developing new schemes to defraud the public. Barnard concluded that securities fraud violators had intellectual ability, business savvy, a lack of empathy and remorse, and were able to rationalize their misconduct. They needed strong interpersonal skills to convince people to invest with them.

In their study of five hedge fund frauds, Muhtaseb and Yang (2008) found that several of the hedge fund principals had received prior sanctions and had also lied about their background and qualifications. Some offenders were highly predatory.

According to Benson and Simpson (2009) white-collar offenders have many ways of rationalizing their behaviour. They report that many high-status offenders do not feel their behaviour is criminal if it is a standard practice in their business. Also, they believe that it is more important to ensure that their business survives than it is to obey the law. These rationalizations receive support from the larger society. Callahan (2004) observes that cheating is common in many fields including sports, law firms, schools, and corporations and claims that this contributes to the view that cheating is normal and that those who follow the rules are putting themselves at a great disadvantage. These rationalizations allow business people to break the law while still seeing themselves as ‘respectable and law-abiding’ citizens.

Benson and Simpson also looked at other psychological factors that may characterize high status white-collar offenders. Some show a sense of superiority over their victims, a trait that was certainly apparent in many of the reports of people involved in the Enron frauds⁸. Related to this sense of superiority and power is arrogance. High status white-

⁷ Some offenders have very long records. Michael Lee Mitton, currently in prison for his role in the Pender International scam, had over 100 convictions, most for stock frauds committed in British Columbia.

⁸ The title of one of the best books about Enron reflected this trait: “The Smartest Guys in the Room” (McLean and Elkind, 2003).

collar offenders are used to getting their own way and feel a sense of entitlement – people who have reached their position in life should be able to set their own rules. Benson and Simpson report that some of these offenders also enjoy the challenge of carrying out a very complex fraud. Finally, they cite research suggesting that white-collar offenders are less socially conscientious than their non-criminal peers⁹. One additional factor not discussed by Benson and Simpson is that people in the securities industry assess risk and take risks in the daily course of their work. Deciding to break the rules may be seen as just another risk that is part of the job, particularly if the individual is working in a corporate environment that facilitates or even encourages deviant behaviour.

Victim Characteristics

The lack of research on white-collar crime means that we know very little about victims of securities fraud. Because of broad participation in pension plans and the popularity of RRSPs, the victims of securities frauds that reduce the value of companies are not just wealthy investors, but are average working Canadians. All investors also lose because of the ‘Canada discount’ that places a risk premium on Canadian securities because of the perception that securities regulations are not well enforced in this country (Task Force to Modernize Securities Regulation in Canada, 2006).

The Canadian Securities Administrators (2007) have conducted a national on-line survey of securities fraud victimization. They found that about five percent of Canadians reported having been directly victimized by securities fraud, twenty percent knew someone who had been victimized, and forty percent had been approached by someone promoting a fraudulent investment. Most victims did not report their victimization. Along with their financial losses, victims reported a loss of trust in others as well as anger, high levels of stress, anxiety, and health problems.

⁹ We should introduce a cautionary note concerning these traits because the research base is very small and because many of these traits may apply to high-status people who conduct their business affairs in a legitimate fashion. Fortunately for many corporate presidents, arrogance is not a crime.

Beyond that general level of victimization, there is also some evidence that, like many other types of crimes, at the individual level there is repeat victimization. For example, Alan and Elliott Benolo were successfully prosecuted for stock swindling by a team including the RCMP, the FBI, and the OSC. The brothers found their victims by purchasing a list of people who had been victimized in another pump and dump fraud (Gray, 2004). They offered these victims the chance to exchange the worthless shares from the previous fraud for shares in blue-chip companies – but only after the victims sent cash to make up some of the difference in share prices.

In one of the few studies of victims, Trahan et al (2004) studied the victims of a large Ponzi scheme in Texas. They found that most of the victims were from that state. The average age was 47. Most (83%) were employed and most had jobs that required at least four years of post-secondary education. Forty-four percent were single males. Perhaps the most interesting finding was that victims apparently recruited others to the scheme. Twenty-five percent of the victims came from four companies and 13 percent came from one company.

Some of the records from the Earl Jones case show just how predatory some fraud offenders can be. Many of his clients were elderly people, some of whom were near-death when he became their advisor. Jones became executor of their estates and was able to drain their accounts while he was settling the estate (Ha and Perreux, 2009). In some cases he was hired to do this by recently bereaved family members.

The Earl Jones case is one of many descriptive accounts that suggest that seniors may be disproportionately vulnerable to fraud. Older people have accumulated more wealth, may be more trusting, and are potentially more easily pressured or bullied by salespeople. They also may be more likely to be misled or may find it difficult to read the fine print. Whether or not research eventually shows that seniors are disproportionately victimized, prevention programs should be targeted at seniors because the loss of retirement savings at a time of life when these savings cannot be replaced can be devastating for the victims.

Factors Contributing To Securities Fraud.

One of the strengths of problem-oriented policing is that it helps us to focus on the factors that contribute to problems like securities fraud. Our knowledge of these factors can help us to outline key intervention points and to identify and to select reduction strategies.

Performance Pressures

There are pressures on investment managers to perform which can lead them to cut legal corners. Also, the complex takeover and merger deals that have become common in business provide many participants with the opportunity for insider trading (Muhtaseb and Yang, 2008). Lou and Wang (2009) found that the amount of financial pressure on a firm and the percentage of complex transactions engaged in by that firm were both related to the likelihood of fraudulent financial reporting.

Corporate Compensation Systems

Corporate executive compensation systems create a moral hazard. It would be hard to design a system that created more incentives for securities fraud than a stock option system that gives senior employees millions of dollars for short-term stock increases. It is unlikely that the accounting misconduct carried out by Enron executives would have occurred if stock options could not have been cashed in until it was clear that profits were long-term.

Investment Business Practices

In their study of hedge fund fraud cases Muhtaseb and Yang (2008) note that the hedge funds they examined were often marketed through independent investment consulting firms. If these advisors have not done due diligence, they may have set up their clients

for fraud victimization. Also, not all of these advisors are honest and may receive incentives to push these funds on investors when they are not suitable investments.

New Types of Investments

Hedge funds and derivatives have created new opportunities for securities fraud that are very difficult for regulators to deal with. Hedge funds have not been transparent because of a lack of regulation and hedge fund managers do not want to reveal their proprietary strategies (Gregoriou and Kelting, 2004). Also, because of the leverage used by these funds, they may be difficult for even sophisticated investors to understand. The potential profits from some of these financial instruments encouraged banks and companies such as Enron to move away from their core businesses and try to increase their income by speculating (Duska, 2004).

New Technologies

The Internet creates opportunities for fraud. It enables fraudsters to communicate easily with large numbers of potential victims, so even a scheme with a very low success rate can be very profitable. Investment chat rooms and blogs enable fraudsters to talk up a stock. Also, the proliferation of investment websites allows more people to invest on their own, so their trades are not run through a broker who could warn them that an investment was potentially fraudulent. Also, Internet-based securities frauds can be operated from anywhere in the world, so enforcement is difficult.

Vulnerability of Victims

For aging baby boomers with growing life expectancies, building and maintaining retirement funds is very important. Millions of Canadians have RRSPs, RRIFs and other investment vehicles, but the average person is not a sophisticated investor. This makes people vulnerable, particularly to frauds such as Ponzi schemes or affinity frauds where

friends, relatives, and co-workers are enthusiastically describing their own investment returns.

Victims may inadvertently help to facilitate fraud. Johnson (2002:14) has described some of the points where the victim makes a decision that helps a fraud artist. These points are important because they suggest where interventions might be made to prevent the fraud:

- “The victim makes the initial contact, or takes steps that lead to the initial contact, indicating receptivity to the pitch.
- The victim provides information about him- or herself that helps the offender to carry out the fraud.
- The victim allows the conversion of a business relationship to one of trust, and waives customary safeguards.
- The victim believes the offender's scenario or pitch.
- The victim writes a check, gives a credit card number, or otherwise provides access to funds.”

Vulnerabilities mean that for many crimes, including securities fraud, the same victims are targeted several times as in the Benolo brothers’ case discussed earlier.

Another factor that facilitates victimization is the inability of people to assess risk. Langevoort (1996) has reviewed the work of behavioral economists and found that even sophisticated investors do not accurately assess the risk of some of their investments. Psychological factors such as the motivation to make more money, the play value of gambling, the desire to ‘keep up with’ other investors, and the tendency to overrate their investment abilities can lead people to underestimate their likelihood of losing money.

Underreporting

Many securities frauds are never reported. One reason for this is that people may not be aware they have been swindled. Losses are common in the stock market and shareholders who see the value of their investments drop to nothing may not be aware of the role that fraud has played in their loss. Others may be too embarrassed to report their victimization. This means that the real extent of securities fraud is not known and also further reduces the likelihood that offenders will receive any penalties for their crimes.

Low Risk of Sanctions

The complexity of securities fraud makes it costly to investigate and to prosecute. Frauds are not a high priority for local police, so they typically do little enforcement. The public is usually more concerned about violent crime and neighbourhood safety issues, so police chiefs are under pressure to invest their resources in these offences. Investigations are extremely expensive and long-term. For example, the investigation of the alleged Nortel frauds took 4 years and 50 people to go through 20 million documents (Toronto Star, June 20, 2008). The amount of information that is involved in these complex cases means that there are lengthy delays in going to trial. It is difficult to keep good investigators because they are often attracted away by much higher salaries in private industry. Even if prosecution is successful, white-collar offenders are seen as good parole risks and are often back in the community after serving one-sixth of their sentences¹⁰. If we add to this scenario the complications of multiple jurisdictions it becomes obvious that we cannot rely only on sanctions to deal with securities fraud.

¹⁰ The government is proposing legislation involving a mandatory 2-year sentence for serious fraud but the legislation will not change the parole eligibility period.

Current Actions to Deal with Securities Fraud in Canada

Securities regulators and others involved in regulating and policing Canadian financial markets have long been criticized for failing to *prevent* fraud from occurring. The shortcomings have stemmed from a number of factors, including limited resources (especially compared to the sheer size of the capital markets and the number of offenders who target investors), a lack of political will to adequately address illegal and unethical conduct, and the inherent challenges in preventing and controlling illegal acts such as insider trading. The proliferation of high-profile cases in recent years has also called into serious question the ability and will of government regulators and industry self-regulatory organizations (SROs) to take proactive steps to prevent fraud from occurring.

While these serious shortcomings exist, a number of measures have been put in place at the industry, regulatory, and criminal enforcement levels in Canada to prevent securities fraud from occurring.¹¹ These preventive measures can be divided into three categories: (1) fundamental components of securities regulation (2) education, and empowerment of investors and (3) intelligence-based regulatory and enforcement initiatives (e.g. market surveillance).

Fundamental Components of Securities Regulation

These regulatory measures are significant proactive measures that facilitate the prevention, deterrence, and/or detection of fraud. They include: (1) the “full, true and timely” registration of brokers and advisors, firms and institutions issuing securities, as well as information relating to securities being issued and (2) initiatives to ensure industry participants are complying with regulations. Non-compliance with these regulatory measures also provides grounds for remedial administrative and criminal penalties.

¹¹ An overview of securities regulation and enforcement in Canada is provided in Appendix 1.

Investor Outreach, Education and Protection

Perhaps the most effective set of proactive initiatives to prevent the defrauding of retail investors is education of investors on financial investing and on fraud exposure.

In recent years, government regulators in Canada have increased efforts to educate retail investors as a way to reduce victimization. The Canadian Securities Administrators (CSA), an umbrella organization representing provincial securities regulatory agencies, was created, in part, to better protect the individual retail investor.¹² A key part of its mission is to harmonize and to strengthen the work of provincial securities regulators in the area of investor protection, including national initiatives. The CSA produces and disseminates a variety of educational materials on securities and investing, including brochures, booklets, and Internet web sites.¹³ It has also taken specific steps to raise awareness of and educate investors as a means to prevent victimization.¹⁴ The CSA gives investor information a prominent place on its website (<http://www.securities-administrators.ca/>). Investor protection information is readily available on the site including enforcement actions, cease trade orders, investment warnings, local fraud prevention resources, and tips on avoiding and reporting scams.

Outreach to investors by securities regulators appears to have improved in recent years, primarily relying on the Internet as the principal medium of communication. In its own words, the Ontario Securities Commission (OSC) “is implementing more effective processes to better identify, articulate and expand on initiatives that both provide protection to, and inform, investors.”¹⁵

To this end, the OSC established the Investor Secretariat and the Investor Education Fund (IEF), which is mandated to better educate investors on investing and other money

¹² A key reason the CSA was created by the provincial securities commissions was to counter the criticisms directed at Canada’s decentralized system of provincially-based securities regulation.

¹³ Canadian Securities Administrators Internet web site, <http://www.securities-administrators.ca/aboutcsa.aspx?id=77>

¹⁴ For example, see the CSA brochure *Protecting Your Money: Avoiding Frauds and Scams*

¹⁵ Ontario Securities Commission, Annual Report, 2009, http://www.osc.gov.on.ca/static/AnnualReports/2009/inv_pro.html

matters. (The IEF is funded through proceeds from OSC enforcement settlements and fines, but operates independently from the OSC). One particularly noteworthy aspect of the IEF and its web site, from a proactive and preventative perspective, is its indirect outreach to children and youth through parents and teachers, which is meant to instill financial literacy and education at a young age.

In March 2009, the OSC launched a new publication, *OSC investor news*, which is focused on regulatory developments that affect investors and investor resources and initiatives (Ontario Securities Commission, 2008, 14).

The OSC's Inquiries & Contact Centre operates an Investor Assistance function that is mandated to help investors understand the securities regulatory system and the role of the OSC. Staff also assists investors to understand how to make a complaint to a securities regulator, self-regulatory organization or other agency.

Other important awareness-raising and information dissemination initiative intended to help protect the investing public is the publication of enforcement actions, including cease trade orders, cases being litigated before the Commission or before the courts, as well as other up-to-date enforcement issues being addressed by the OSC, the Investment Industry Regulatory Organization of Canada (IIROC) or the Mutual Fund Dealers Association of Canada (MFDA).¹⁶

The OSC has also undertaken initiatives that are meant to raise awareness of and educate investors on fraud. The OSC's 2008/09 *Statement of Priorities* report includes such priorities as: developing new fraud prevention resources, including a "Boiler Room Factsheet" (in conjunction with the CSA), creating an on-line fraud awareness quiz, and "new website content in an online advertising campaign as part of Fraud Prevention Month." Indeed, March is designated as "fraud prevention month," which has involved an

¹⁶ This information is disseminated through the web site, http://www.osc.gov.on.ca/en/Proceedings_index.htm

“integrated media and outreach campaign” by the CSA and provincial securities regulators across the country (Ontario Securities Commission, 2008, 14).

Also in the realm of investor outreach, education and protection are the joint efforts by the CSA, the IIROC and the MFDA “to develop an effective and harmonized framework for the client complaint handling process. The framework sets out standards and timelines for acknowledging, investigating and responding to client complaints. The framework also contemplates that registered firms will monitor complaints and report them to management in order to allow the detection of frequent and repetitive complaints that may, on a cumulative basis, indicate a problem.”¹⁷ The OSC has also recently improved its handling of investor complaints (Ontario Securities Commission, 2008, 11). The OSC web site provides a complaint reporting process that can be completed on-line (complaints can also be made on-line through the IIROC web site).¹⁸

Complementing the provincial securities regulators complaint reporting process is RECOL, a web-based (www.recol.ca) crime-reporting centre for individuals wishing to make a complaint concerning suspected fraud or other white-collar crimes in Canada. Any reports made through the site are directed to the appropriate law enforcement agency or other relevant organization. RECOL also provides public education through the dissemination of crime prevention information, and collects baseline data on fraud, with a view to identifying crime trends and compiling statistical information. The RCMP and Ontario Provincial Police also jointly operate Phonebusters (<http://www.phonebusters.com/>), an Internet and telephone-based fraud-reporting centre.

Despite these improvements, there are still some weaknesses with respect to the education and empowerment of investors, especially given the average consumer’s increased exposure to fraud risks because of the proliferation of communication

¹⁷ Ontario Securities Commission web site, http://www.osc.gov.on.ca/static/_/AnnualReports/2009/inv_pro.html

¹⁸ Investment Industry Regulatory Organization of Canada Internet web site, http://forms.iiroc.ca/CustomerComplaintForm/InitialSelect_en.asp

intermediaries (Internet web sites, chat rooms, blogs, email, text messaging, social networking sites) that can be used to reach consumers.

For example, our e-mail inboxes are constantly filled with unsolicited advance fee fraud entreaties or highly questionable solicitations for investments, but it is virtually unheard of to receive e-mails from government or industry sources that send warnings of or educate the public on such scams¹⁹.

Government regulators, such as the OSC and CSA, appear to have taken a “build it and they shall come” approach, whereby resources are available on their web sites, but limited efforts seem to be made to proactively and directly disseminate information to investors. There seems to be a lack of information dissemination through both traditional and emerging technologies, including those that can be received in “real time,” which is critical to preventing initial or further victimization (for example, text messages, e-mails, RSS feeds, as well as popular internet sites, such as Facebook, Twitter, and YouTube).

Intelligence-Based Regulatory and Enforcement Initiatives

Beyond the initiatives that revolve around educating, empowering, and involving retailer investors to prevent victimization are intelligence-based enforcement measures undertaken by government regulators and police that can potentially identify, detect, deter, and prevent fraud. This includes ongoing market surveillance mechanisms undertaken by stock exchanges, self-regulatory organizations (SROs), and provincial regulators. In his report evaluating the Integrated Market Enforcement Teams, Nick Le Pan cites the work of these teams and the Joint Securities Intelligence Units as important measures that can detect and deter securities fraud (Le Pan, 2007, 15).

¹⁹ While it did not use e-mail, the Executive Director of the BC Securities Commission recently reported an initiative that responded to a securities fraud targeting the Indo-Canadian community by issuing an alert to local media – the first time this had been done by a Canadian securities regulator (Leong, 2007). An appearance by a provincial cabinet minister on a Punjabi radio station led to information that assisted the Commission with its investigation.

Just as technology has helped facilitate securities fraud, it can also be used to reduce fraud. Van der Laan and his colleagues (2010) have described a technical tool (Scamalyzr) used by the New Brunswick Securities Commission to identify potential securities fraud websites. Developing and using tools like this one can be valuable steps in intelligence-based regulation and enforcement.

Applying Problem–Oriented Policing to Securities Fraud

A core principle of the problem-oriented approach to crime problems is that people with expertise in particular problems work together using up to date information about local problems with the goal of developing long-term solutions. Thus there are no templates that can be automatically applied to problems. That said, we can suggest some possible measures that should be considered in looking for ways to prevent securities fraud. These measures include: improved investor education; intelligence-led policing; ethics programs; better regulation of compliance programs; increased use of private-sector policing; and multi-agency partnerships.

Case Study: Using POP to Reduce Fraud Against Seniors in Nassau County, Florida

We could not find any systematic attempts to apply problem-oriented policing to securities fraud. However, one program dealing with other types of fraud provides a model of one way this approach might work.

In 1995, the Nassau County Police Department solicited help from seniors groups, the district attorney's office, and the business community to identify the extent of the fraud problems against seniors and to develop effective prevention measures. Statistics in one Nassau County precinct revealed 60 incidents of fraud against seniors between 1992 and 1995. While seniors were well versed in telemarketing and mail fraud, they were still being victimized by home improvement scams and burglaries by individuals posing as utility company employees.

Police found that one of the biggest obstacles to combating this problem was that many frauds perpetrated against the elderly go unreported due to their embarrassment of being scammed or their inability to grasp the complexity of the fraud. The police determined that proactive communication and intervention were essential. In cooperation with seniors groups and the private sector, the police developed a multi-faceted strategy that included the following components:

- increased education and information dissemination to the public, such as providing bank customers with cash withdrawal alert forms that includes information on the latest scams;
- training bank tellers on the latest fraud techniques;
- working with banks to detect fraud early by developing a warning system that identifies practices inconsistent with a senior's banking history;
- enhanced police training to raise officer awareness of the problem and ensure accurate reporting and classification,;
- educating police officers on all available resources to combat fraud, including the use of municipal laws and consumer affair regulations;
- encouraging seniors and others to use certified cheques, money orders, or wire transfers in lieu of large cash withdrawals; and
- engaging the help of utility companies to distribute anti-fraud pamphlets with billing statements.

The impact of this program includes a 53 percent drop in reported cases of frauds/scams countywide (from 32 in 1997 to 17 in 1998) (Hicks, Denat, and Arsenault, 2000).

Improved Investor Education

Fraud prevention can be directed at numerous targets: companies and brokers who may use risk-excessive, unethical or fraudulent tactics; the markets themselves; and government and industry regulators. However, most fraud is directed at victimizing retail investors so efforts to prevent fraud must emphasize protecting these investors by educating them about fraud and other dubious investment opportunities. Particular emphasis must be placed on the timely release of information (especially to counter fraud scams that may be making the rounds at any one time), proactive and direct outreach to investors using real-time medias, and specific tips on how to avoid being taken in.

One central message needs to be constantly reiterated in communications with investors - if it appears too good to be true, it is probably a scam! In other words, consumers need to be constantly reminded that investment opportunities that are marketed with above average returns or other warning signs are mostly likely scams and should be avoided and/or reported. They also need to be educated on how to check out the people with whom they are investing their money. There are public sources – most of which are online - that can be examined and Gregoriou and Kelting (2004) have prepared an investors' checklist for people who are planning to make a significant investment in a hedge fund.

While educational efforts have been made, much more needs to be done, including seniors programs such as the Nassau model described earlier. A comprehensive nation-wide communication/education strategy must be developed. This campaign must rival that of the fraudsters. Innovative ways must be found to reach the public and greater resources must be invested in education.

Intelligence-Led Policing

A problem-oriented approach to crime is built on an analytical process in which the scope and nature of a crime problem, criminal act, or criminal behaviour is assessed through the gathering and analysis of relevant information. The problem-oriented approach encourages key stakeholders to identify and to solve the causes and facilitators behind particular crime and disorder problems. This analytical process differs from the traditional reactive, incident-driven model, where police generally follow a routinized approach to crime problems (search for, arrest, and prosecute the offender through the criminal justice system).

Closely related to problem-oriented policing is intelligence-led policing (ILP), which is also “built around risk assessment and risk management” (de Lint, 2006, 2). Although there is no universally accepted understanding of what intelligence-led policing entails, one definition is that ILP is “a strategic, future-oriented and targeted approach to crime control, focusing upon the identification, analysis and ‘management’ of persisting and developing ‘problems’ or ‘risks’” (de Lint, 2006, 2-3). In simpler terms, according to the RCMP, “intelligence-led policing requires reliance on intelligence before decisions are taken, be they tactical or strategic.”²⁰ The idea behind ILP is for police to spend more time employing informants and surveillance to identify and target high-risk and/or recidivist offenders and devising strategic interventions based on that intelligence. ILP is congruent with problem-oriented policing because it encompasses some of its principle tenets, such as gathering and analyzing sufficient amounts of information, and then developing strategies that are commensurate with the scope and nature of the offence or offender targeted²¹.

An intelligence-led regulation and policing approach to securities fraud would entail a risk-based approach that uses various information sources – computerized market

²⁰ Royal Canadian Mounted Police, Criminal Intelligence Program, Internet Web site, <http://www.rcmp-grc.gc.ca/ci-rc/index-eng.htm>

²¹ Tilley (2003) has pointed out that at least in the U.K., intelligence-led policing is rather insular and relies on police-based solutions. However, the logic of the approach is easily adaptable to a broader model involving other agencies working cooperatively with the police.

surveillance, Internet (web site and chat room) monitoring, victims, and other human sources (informants and agents) to generate information that can be analyzed and used to proactively (and reactively) target potential or existing fraud schemes, high risk and recidivist perpetrators, and the mediums being used to commit frauds to prevent and/or reduce the harm of the fraud.

One example of how this knowledge can be applied comes from the relatively new practice of individualized deterrence. This strategy uses intelligence and analysis to identify high-rate and high-risk offenders. These potential repeat offenders are personally informed that their actions are being monitored and that there will be zero tolerance for any future misconduct. Enforcement resources are focused on these potential repeat offenders to ensure that they are intensively supervised in the community. This has been very successful in reducing gang homicides in Boston (Kennedy, 2009) and auto theft in Winnipeg (Linden, 2008) and should be generalizable to other types of offenses.

An analysis of the regulatory and enforcement measures in place in the Canadian securities market reveals that many of the tenets of the problem-oriented and intelligence-led policing are employed by government and industry regulators and police. Canadian stock exchanges, SROS, regulatory bodies, and police utilize automated and human-based sources, data gathering tools, and analytical tools to collect information to identify market irregularities, including fraud.

According to the Canadian Securities Administrators (2010, 30), “Market surveillance is a focus of enforcement staff at the OSC. Trading patterns are monitored for unusual activity. Staff move expeditiously for interim orders (both temporary cease trade orders and removal of exemptions and freeze directions) in circumstances where it is necessary to stop ongoing harm.”

The Joint Securities Intelligence Units and IMETs are specifically geared towards collecting, analyzing, and utilizing information to detect and deter ongoing conspiracies

and those that present the highest risk and criminal activity in the capital markets (Canadian Securities Administrators, 2010, 30). According to one RCMP IMET manager,

...the RCMP has also taken a leading role in the development of the Market Integrity Computer Analysis system (“MICA”). MICA was developed by a consortium of partners from the provincial securities commissions, stock exchanges, the Investment Dealers Association and the RCMP. The system is now fully operational and allows administrators and investigators to review and analyze trading activity pertaining to specific securities and produce subsequent evidentiary summary reports for use in both administrative proceedings and criminal prosecutions. MICA is a good example of complex investigator techniques being encoded into an expert computer system (Sliter, 2000, 161).

Information gathered through market surveillance, other intelligence sources and investigations are then used as a basis for awareness-raising and educational campaigns for investors and the development of rules, policies and programs designed to address the fraud problems that have been identified.

One area that still needs improvement is that of using the information gathered through regulation, intelligence, and enforcement to provide a better understanding of the causes and consequences of securities fraud in Canada. It would be very useful to use the information gathered from intelligence and investigations for more scholarly research that would be geared toward a theoretical and empirical understanding of the causes of fraud within the securities industry, including an understanding of one-time or chronic offenders and the risk factors that fostered their criminality as well as the risk factors that created the opportunities for such crimes to occur. Research on victim characteristics is also needed. What is needed is a long-term research endeavour that would entail a partnership between scholarly researchers, securities industry actors, and those responsible for policing the securities market. The goal of this research would be to increase our understanding of the scope, nature and causes of securities fraud -

information that can then be applied to counter the problem in a more proactive and preventive way.

Mandatory Ethics Training for Securities Industry Participants

Analysis of many serious securities frauds has shown that while some of those involved were acting out of greed, others were participating because of their loyalty to their companies. For example, WorldCom financial personnel broke accounting rules because they felt this would help the company get through difficult times (Callahan, 2005). While rules demanding better performance from directors and auditors are necessary, these rules may not have much impact on the people keeping the company's books. In addition to more careful oversight, these people need to learn to think and to act ethically when their employer breaks the rules.

Within the context of the regulation of the financial markets, and the prevention and control of fraud, one must also emphasize the critical importance of the ethics and integrity of industry players. No level of industry self-regulation, government regulation, or criminal enforcement can replace a high level of ethical and honest behaviour among industry participants as the principal bulwark against fraud or other deceitful practices perpetrated by those within the industry. This applies to brokers, fund managers, directors or officers of public companies, as well as accountants or lawyers who are also entrusted with ensuring the fiduciary responsibilities of publicly traded corporations. A critical role of industry and government regulation is ensuring a high level of market integrity and ethical practices of those within the industry. As John Sliter writes, "the integrity of business, in particular the banking and financial services marketplace, depends heavily on the perception that it functions within a framework of high legal, professional and ethical standards. A reputation for integrity is one of the most valuable assets of big business ... There are strong economic arguments to encourage all levels of government to protect the integrity of their corporate culture" (Sliter, 2006, 383).

Ethics courses and other training should be a part of MBA programs, other certification accreditation bodies (securities trader, financial advisor, etc.), and part of company training programs. Beyond simply training people in ethics, company officers should be obliged to ensure that an ethical culture²² prevails within their organizations. Bussman and Werle (2006) suggest that ethics programs provide specific behavioural guidelines including information on the conduct that is prohibited by the law. These guidelines need to be enforced and senior managers need to demonstrate ethical conduct themselves.

Increasing the Role of Non-State Actors in Preventing and Controlling Securities Fraud

A broad range of non-state actors can potentially be involved in preventing and controlling securities fraud, including the financial services industry (e.g., the IIROC), the private policing and forensic accounting industries, and private citizens in their capacities as consumers and retail investors. As the financial services industry is already an active player in the regulation of the markets, this section will deal primarily with private citizens and the private policing sector.

The Investor Community

In addition to the current measures that educate and empower individual retail investors, we can adapt some lessons learned from community crime prevention and move beyond empowering the individual investor to creating a cohesive and vigilant investing community. This might be accomplished by promoting non-profit investing advocacy groups, by using Internet web sites and chat rooms to build an investing community that can help prevent frauds from occurring.

²² The Task Force to Modernize Securities Regulation in Canada (2006) refers to the need to develop a 'compliance culture' to help ensure that securities regulations are followed.

To increase a sense of collective efficacy, shareholder rights and powers should also be increased. This should include holding the directors and officers of public companies responsible for actions such as shirking fiduciary responsibilities that lead to investor fraud victimization. One option would be to heed the calls for a “statutory national investor organization,” which was recommended by the Task Force to Modernize Securities Legislation in Canada (2006).in their 2006 report, *Canada Steps Up*.²³

At the level of the individual investor, laws and regulations could be put in place that facilitate victimized investor reprisals against fraudsters, in part to recoup investment losses. Measures need to be taken to facilitate class-action lawsuits by investors against public companies, fraudsters, the industry, and even regulators (while avoiding frivolous lawsuits). Victimized investors should also be placed at the front of the line to be reimbursed from the proceeds of crime forfeited from convicted offenders.

These investor rights could be enshrined in law. The Sarbanes-Oxley Act in the U.S., which protects fraud victims’ rights to recover assets, is one model that can possibly be emulated in Canada with respect to protecting investors’ rights and investments.

Private Policing and Forensic Accounting

In recent years, there has been a proliferation of private sector firms that offer financial investigative services, including forensic accounting. As this sector of the accounting profession has developed, accounting and private investigative firms began recruiting senior investigators from the RCMP as well as from provincial and municipal police forces and relevant regulatory agencies to complement their accounting resources and to develop a sophisticated and wide-ranging financial investigative capacity. In addition to accountants and police officers, these firms also employ other relevant professionals, including criminologists, security specialists, intelligence analysts, MBAs, and computer

²³ Task Force to Modernize Securities Legislation in Canada. 2006. *Canada Steps Up*. <http://www.tfmsl.ca/index.htm>. Accessed 30 March 2010.

specialists. Today, forensic accounting practices and firms provide a number of investigative, risk management, and consulting services to the public and private sectors.

Forensic accountants have been recognized as integral partners in fraud and money laundering detection and enforcement. Former law enforcement personnel working in the private sector bring a depth and range of relevant experience and expertise. Experienced former police officers within the private sector can often carry out investigations more expediently and efficiently than junior members of public police agencies, which can potentially contribute to successful case closures. According to one industry insider:

The timeliness of private investigation versus the criminal justice system is seen in the Bre-X fraud. Within 10 days of being brought into the case, Forensic Investigative Associates (FIA) had a team of investigators at the mine site in Indonesia. FIA's complete report was presented in less than six months. The RCMP on site investigation started three month's after FIA's and its report was made 1½ years after FIA's (Hunt, 2000, 139).

In 1983, the President of the International Association of Chiefs of Police stated,

With respect to white-collar crime and other frauds, private investigators have proven themselves far more knowledgeable about the nuances of their particular industries than public police. Proprietary investigators represent a first line of defence in computer security, corporate espionage, asset protection, access control, and the myriad other economy-related offenses that invade the corporate structure (as cited in Mitchell, 1999, 7).

In addition to accountants and police officers, forensic accounting practices also boast a wide range of relevant professionals, including those with expertise and contacts in industries vulnerable to economic and organized crime activities. The largest accounting firms boast a national and international structure, which is less apparent in the public law enforcement field.

Notwithstanding their investigative capacity, perhaps the most beneficial role that can be played by private security FIAs in efforts to combat fraud and organized crimes in the securities market would be preventative in nature; that is, helping corporate clients comply with industry rules, provincial securities regulations and federal transaction reporting legislation. By extension, they could play a role in detecting and reporting suspicious activities and persons to government agencies. Within the context of a cooperative and coordinated approach with the public sector, this role would complement the largely reactive, incident-driven, investigative role of public law enforcement agencies.

The role of FIAs in combating fraud should also be pursued in the context of greater cooperation and coordination between private and public policing organizations. An innovative example of one type partnership that can possibly be emulated with respect to the securities market has been pursued by the Financial Investigations Division of the U.S. Bureau of Immigration and Customs Enforcement, which maintains standing contracts with private sector entities. Officially designated as “law enforcement assistance agencies” (often ex-law enforcement personnel) these private sector entities undertake initial intelligence gathering for tactical investigations in cities and other locations where there are no experienced customs agents available. The purpose of this work is to identify investigative leads, which can then be turned over to Bureau agents, and/or to determine whether a criminal investigation should ensue. These private investigators have access to Customs databases, but have no law enforcement powers. The use of private sector personnel also provides flexibility for the Bureau in being able to hire individuals with specific areas of expertise relevant to a particular file. Contracting out on a case-by-case basis can also be less expensive than hiring government employees. Based on their experience, the private contractors also help train and educate Bureau agents in a quasi-mentoring relationship.

Multi-Agency Partnerships

Efforts to combat white-collar crime have often been characterized by the unilateral actions of individual law enforcement agencies within their respective jurisdictions. Multi-agency coordination and cooperation has been hampered by factors such as jurisdictional boundaries, differing mandates, rivalries, and a lack of communication and intelligence sharing among participating agencies. In recent years, a consensus has emerged that efforts to combat major, multi-jurisdictional criminal and national security threats must entail a coordinated approach involving agencies inside and outside the criminal justice system. This multi-agency cooperation has been deemed essential given the multi-jurisdictional nature of financial and organized crime, as well as the need to pool expertise, powers, and limited resources. Also, a recent study in the U.K. found that action taken by regulatory agencies was faster, more likely to find the offender had acted wrongfully, and to have provided protection for the public through restricting the offender's practice, than the action taken by the criminal courts (Middleton, 2005).

There are already several multi-agency partnerships working on securities fraud control in Canada. Within government, securities regulators have come together in a national umbrella organization, the CSA, which is mandated to effect greater cooperation, coordination, and harmonization among provincial securities regulators. One result of this cooperation has been the implementation of 'reciprocal orders' that can be used by each provincial regulator to prevent individuals and companies who have been sanctioned in another jurisdiction from engaging in similar misconduct in another.

These collaborative initiatives have been undertaken to counter the growing criticism over Canada's highly decentralized and fractionalized approach to securities regulation, which runs contrary to the increasingly cross-jurisdictional nature of organized fraud schemes. Despite the creation of the CSA and the harmonization of provincial securities regulations, inter-provincial cooperation can still be more cumbersome and less effective than a single securities regulator. The Canadian Expert Panel on Securities Regulation concluded that "The shortcomings of the present system are clear: it remains too slow,

too cumbersome, and too expensive. At a time when speed counts, policy development is protracted, negatively affecting Canada's ability to respond in a timely manner to national and global developments" (2009, 2).

The Integrated Market Enforcement Teams are another example of a multi-agency partnership. According to Sliter (2006, 384), "The 'integrated policing' philosophy involves all levels of law enforcement working cohesively with each other, exchanging strategic and criminal intelligence, sharing tactical and operational knowledge, planning joint and individual actions and communicating effectively."

The IMETs are a significant addition to securities enforcement in Canada, although they have been criticized for a lack of results (see Le Pan, 2007). Another integrated, multi-agency initiative is the Joint Securities Intelligence Units, which include analysts from securities regulatory bodies, police, and the securities industry. The JSIU targets criminal syndicates and organized crime groups operating within the Canadian capital markets. A key objective is to detect and disrupt wrongdoing in the capital markets before investors are harmed.

Finally, there appears to be increased cooperation and coordination at the international level, which is deemed increasingly important given the growing transnational nature of securities fraud as well as other types of fraud. According to the Ontario Securities Commission, "in 2008–09, the OSC responded to some 500 enforcement-related assistance and information requests from international regulators and agencies ... For example, in 2008, the OSC provided assistance to an SEC initiative to protect investors from potentially fraudulent spam e-mails that promoted stock investments. The SEC campaign resulted in the suspension of trading in the securities of 35 companies".²⁴

The one key stakeholder that appears to be missing in these multi-agency partnerships is someone to represent investors. Given the importance of empowering consumers to

²⁴ Ontario Securities Commission Internet web site, <http://www.osc.gov.on.ca/static/AnnualReports/2009/enf.html>

take an active role in preventing fraud victimization, groups representing investors, such as the Canadian Foundation for Advancement of Investor Rights, should be involved in multi-agency partnerships along with government and industry groups. At the strategic level, this could include sitting on policy committee, while at a more tactical level these groups should be allowed to sit on committees, working groups, or even regulatory and enforcement task forces that directly deal with policies and operations that directly affect investors, including their possible victimization. In the context of combating fraud, investor advocacy groups should be treated less as a “client” by government or industry and more as a key stakeholder.

While different governmental and industry bodies have enacted many complementary initiatives, there is a need to develop a national strategy that places at its core a coherent, comprehensive securities fraud prevention strategy. This strategy should be developed by key stakeholders – the Canadian Securities Administrators, the Investment Industry Regulatory Organization of Canada, the Mutual Fund Dealers Association of Canada, the Autorité des marchés financiers, the stock exchanges, police, online fraud reporting agencies, and consumer groups – and should address identified shortcomings, while building efforts to prevent fraud through more effective regulation, education and enhanced enforcement initiatives. The international dimension of securities fraud means that international linkages will also be necessary.

A Research Agenda

At the strategic level, a problem-oriented approach entails understanding how a certain type of fraud or type of offender emerges and persists within the securities market. This information is used to help enact fundamental measures to address the causes of these frauds or offenders.

It is the mandate of the scholarly community to study the causes and consequences of white-collar crime. However, there is probably no area of criminology where reliable scholarship has proven so elusive. There is a lack of scholarly research into securities

fraud, including the analysis of industry data, which can be used to advance a better theoretical and empirical understanding of the nature, scope, causes, and impacts of such fraud.

Thus, it is recommended that initiatives be undertaken within the securities industry, and between the industry, government regulators, and scholars, to develop a comprehensive and rigorous research agenda, that encompasses the tactical, strategic, and etiological levels of analysis articulated above. Particular emphasis should be placed on the use of such information to inform a better etiological understanding of securities fraud (as this is not only the largest void, but also an area that is the domain of scholars). The results of such a research agenda should be used for both basic and applied purposes.

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