

The economics of white-collar crime:

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The Economics of White-Collar Crime: An Economic Analysis of Insider

Trading in Canada Introduction In the past decade, white-collar crime such as illegal insider trading, banking fraud, ponzi schemes, corporate embezzlement and political money laundering has reached an all-time high. In North America alone, respected and highly influential individuals such as Martha Stewart, Bernie Madoff, and Conrad Black have been prosecuted for their crimes and companies such as Fannie Mae and AIG were brought before congressional committees. Unfortunately, while the above individuals were prosecuted and convicted, white-collar crime persists today and the resulting negative economic effects are numerous. Individuals and corporations alike reduce investment after falling victim to white-collar crime and economies suffer as a result. Billions of dollars are lost annually and public trust in the economic system is seriously diminished. Moreover, white-collar crime contributes to an increase in the cost of doing business as firms put increasing amounts of money into prevention procedures. The increased costs impacts consumers through higher prices and a lower quality of service. Enforcement is also a major issue. Unlike traditional forms of criminal behaviour, many white-collar crimes are especially difficult to prosecute. Perpetrators often use sophisticated means to conceal their activities through a series of complex transactions and tracing their maneuvers is extremely challenging. Furthermore, while corporate crimes often cost billions of dollars, because losses are frequently spread out over numerous unaware victims, many white-collar crimes are never reported. As a result, many crimes go unnoticed and an accurate valuation of white-collar crime is difficult to determine. Similarly concerning is the fact that white-

collar crime is not unique to North America. As a direct result of advances in technology, the international arena has experienced a dramatic growth in white-collar crime as well. Globalization has facilitated more efficient methods of travel and communication, and the result has been an increase in the movement of goods, services and capital. Consequently, white-collar criminals have access to a larger base of victims as they can now conduct their operations on an international scale. In short, white collar-crime has significant and wide reaching consequences. Billions of dollars are lost annually, and economies are suffering as a result. Due to globalization and advances in technology, the problem is growing and enforcement is becoming increasingly difficult. Fortunately, the present situation offers a perfect occasion to analyze the motivations behind white-collar criminals and the problems facing securities regulators. Moreover, the current context of crisis also presents a key opportunity in which to evaluate alternative agendas for combating the problem. In the pages that follow, the paper will provide an economic analysis of white-collar crime. Specifically, the paper will proceed in two parts. Part I will provide background information on white-collar crime and an economic analysis of the motivations behind why white-collar criminals engage in illegal activity. Part II will provide detailed analysis of insider trading in Canada. A discussion of the Canadian enforcement system and new approaches to deterrence will also be provided. The goal of the paper is to shed light on the economics behind insider trading and the increasing prevalence of illegal insider trades in the Canadian market. PART I —White-Collar Crime A Brief History of White Collar Crime Edwin Sutherland of the American Sociological Society coined the phrase “ white-collar crime”

in 1939 during a presidential address to his peers. Sutherland defined the term as " crime committed by a person of respectability and high social status in the course of his occupation." Although this definition leaves room for debate as to what qualifies as a white-collar crime, the term generally encompasses a variety of nonviolent crimes whereby an individual seeking financial gain uses his or her authority (apparent or real) to take advantage of the simple opportunity structures available within business. Crimes such as embezzlement, fraud, money laundering, and illegal insider trading, are perfect examples. In each situation, a person of authority takes advantage of his or her position for the purpose of personal or corporate monetary gain. While many may think that white-collar crime is a relatively new concept, it has actually existed in business for over 2000 years. Cases of fraud date back as far as 360 B. C., when Xenothemis and Hegestratos, two residents of a Greek colony called Syracuse, conspired to swindle a commodity broker through a fraud scheme. The two men asked the unsuspecting broker for an advance on a shipment of corn they claimed was loaded on a vessel owned by Hegestratos. Their intention was to sink the vessel at sea and keep the money for the non-existent corn. Hegestratos, however, when caught by passengers in the act of sinking the ship, panicked and drowned when he jumped overboard. While the men's actions do not fit squarely within Sutherland's definition, it is clear that their attempt to trick the commodity broker was a form of white-collar crime. This is true for the simple reason that Xenothemis and Hegestratos tried to take advantage of their position in business at the expense of a customer. Unfortunately, with no formal enforcement mechanisms coming into existence until the mid 20th century,

the story of Xenothemis and Hegestratos was undoubtedly the first of many white-collar crimes to take place over the past 2000 years. Accordingly, much of what is now considered white-collar crime was formerly considered a normal, if somewhat underhanded, part of doing business. Moreover, given the majority of notable white-collar criminals operated post 1800, it is not surprising that Sutherland's definition referred to a person of "respectability and high social status". Fittingly, some of the most notable "captains of industry" of the 19th century were known to stretch their business ethics. Among some of the more notorious businessmen known to employ what would be considered today as white-collar crime techniques, were Schuyler Colfax, former vice-president, and James Garfield, the 20th president of the United States. Both of which were people of "respectability and high social status". Colfax and Garfield were both involved in the Credit Mobilier scandal of the mid-1800s whereby the U. S. government lent Credit Mobilier various sums of money for each mile of railroad track laid. The amounts increased with the difficulty involved in engineering the respective project and the loans topped out at \$48, 000 per mile of rail laid in the mountains. Credit Mobilier charged another company, Union Pacific, huge sums for its services and much of it for work that was never completed. The major stockholders, including Colfax and Gardield, owned stock in both Credit Mobilier and the Unioin Pacific Railroad. As a result, both Colfax and Garfield along with the other major stockholders earned millions in profits; much of it government money. While, the New York Sun suspected financial corruption in the building of the railroad and revealed such in 1872, a senate investigating committee absolved the politicians of any wrongdoing. White-collar crime

expanded significantly during the 20th century as nearly every decade produced a white-collar criminal who made newspaper headlines. The 1920s saw the rise of Charles Ponzi whose name lives on in the term " Ponzi Scheme." The 1950s had John Rigas, who created Adelphia Communications to hide \$2.3 billion in debt and false earnings that he and his sons used to for personal fun. The 1990s saw fraudsters like the Kenneth Lay of Enron and Bernie Madoff of Madoff Investment Securities LLC steal billions from innocent victims by using sophisticated transactions to conceal their corrupt business practices. The list goes on. In sum, white-collar crime is not a new phenomenon. It has existed for over 2000 years and its frequency has only increased over that time period. More precisely, it has expanded at an exponential rate. An increasing number of perpetrators are discovered each year and although due largely in part to better detection measures, the increase cannot be ignored. White Collar Crime in Canada While the majority of white-collar crime headlines come from the U. S., a 2011 survey done by Price Waterhouse Coopers indicated that white-collar crime is quite prevalent in Canada. According to PWC, of the approximate 4000 global companies surveyed, 34% indicated that they had suffered from fraudulent acts in the past year. Regrettably, even with advanced detection methods and millions of dollars spent on prevention Canada sits only slightly below the 34% mark as 32% of Canadian corporations reported being victims of fraud. Given that many of the countries surveyed do not have a securities regulator, Canada's situation is particularly disappointing. With respect to civil victims, it is estimated by the Canadian Securities Administrators (CSA) that one million adult Canadians (nearly 5%) have lost money to some kind of investment

fraud or another form of white-collar crime. Furthermore, one third of these victims reported that investment fraud alone " had an extreme or significant impact on their personal finances. Such losses are also known to have additional impacts on the psychological, emotional, and therefore physical health of individual victims. According to the CSA, victims of fraud report high incidences of stress, anger, depression, loss and isolation. This is especially true among those that lost more than \$10, 000. Additionally concerning for Canadians is the fact that there are extensive links between white-collar crime and organized crime (i. e., that which works toward generating profits, through the drug trade, human smuggling or seemingly legitimate business ventures such as the construction industry). The city of Montreal in the Province of Quebec is a perfect example. Montreal is a hotbed for organized crime in Canada and it has long been expected that corruption and white-collar crime — including the infiltration of organized crime in the construction industry and municipal affairs — has funded much of the various crime syndicates' criminal activity. Specifically, a 2009 Radio-Canada investigation quoted sources who said municipal public-works contracts in the Montreal region were as much as 35-per-cent higher than they should be because a group of construction companies run by organized crime syndicates control the bidding process. Insider trading is also a major issue in Canada. While the first criminal conviction for illegal insider trading occurred on November 6, 2009 — when Justice Robert Bigelow of the Ontario Court of Justice accepted a guilty plea from Stan Grmovsek — there have been none since and a number of suspicious trades have gone unprosecuted over the past decade. For example, in mid-October of 2002, three senior

officers of Humpty Dumpty Snack Foods Inc. bought nearly 500, 000 shares at \$2 in their own company. Ten days after the last purchase, Dominion Citrus Ltd. made a hostile bid for Humpty Dumpty at \$3. 25 per share. The stock price rose accordingly and the executives, by virtue of their ' good timing,' had earned almost one half of one million dollars in less than three weeks. Although illegal insider trading was suspected, the Ontario Securities Commission (OSC) did not pursue the case. Put simply, white-collar crime is quite prevalent in Canada. Criminals like Stan Grmocsek and organized crime syndicates are operating across the country and as the above indicates, much of it goes unprosecuted. Canada is facing serious challenges when it comes to combating white-collar crime and to date, little success has been achieved. Reasons for the lack of success in combatting white-collar crime will be discussed below but it is important to note that even in a country like Canada, with significant regulatory and enforcement measures in place, it is relatively easy for white-collar criminals to conduct their operations.

Motivation — Why do people commit white-collar crimes? a) Rational Choice Theory In an influential paper on the economics of crime, Gary Becker of the University of Chicago set out a framework to answer the question “ why do people commit crime? ” Becker hypothesized that criminals, like other rational actors, criminals perform simple cost benefit analyses when deciding whether or not to commit a crime. Interestingly, his theory was the result of an experience he had when he was late for an appointment. Becker was trying to find a parking spot and he had to weigh the cost and benefits of parking legally in an inconvenient garage versus parking in an illegal but convenient space close to his destination. After performing a rough

calculation of the probability of getting caught and potential punishment, Becker rationally opted for the crime. From this, Becker inferred that other criminals make such rational decisions. More precisely, Becker hypothesized that criminals make their decisions about compliance with criminal law on the basis of a comparison of the expected costs and benefits of criminal and legal activity. The expected costs of crime result from multiplying the probabilities of the activity being detected and of the perpetrator's being apprehended and convicted by the monetary value of the legal sanction and the value of any non-pecuniary losses he might suffer, such as a loss in reputation from being branded a criminal. The expected benefits of the crime result from multiplying the probability of success by the monetary and non-pecuniary benefits of the particular crime. These monetary and non-pecuniary benefits include both the value of the goods or money resulting directly from crime and such intangible but potentially valuable outcomes as being known in one's community as a law-breaker. According to the Becker model, the rational criminal will commit the crime if these expected costs are less than the expected benefits and will refrain from crime if the reverse is true. At the time, such a premise went against conventional criminal theory that assumed that crime was a result of mental illness and social oppression. However, and not without criticism, the Becker Model has stood as an authoritative theory on crime since it was published in 1968. With respect to white-collar crime, it appears that Becker's model is applicable. Just as Becker calculated the probability of getting caught when deciding whether or not to park illegally, it is entirely likely that potential white-collar criminals perform a similar calculation when deciding whether or not to perform a

trade with inside information or set up a fake corporation to hide losses. Criminals look at the potential benefit of committing a white-collar criminal act and they weigh the risks versus the rewards. Unfortunately, given the lack of prosecutions of white-collar criminals and the relatively tolerable prison sentences — such as Martha Stewart's five-month incarceration plus five months of home confinement for illegal insider trading — it is completely plausible that the decision for potential perpetrators is a fairly easy one. This is especially true in Canada given the current state of enforcement and relatively low prosecution rate of white-collar criminals. It follows that white-collar crimes should be taking place on a regular basis. With the chances of getting caught being low and the benefits ranging from thousands to billions of dollars, would be criminals should have little difficulty in deciding to act deviously. A 2011 study by KPMG supports this hypothesis. The study indicated that both the number of cases and the total amount of losses as a result of white-collar crime clearly rose in 2011 in comparison with the previous year. Furthermore, a new Gallup Poll revealed that two in three adults worldwide believe business corruption is widespread in their countries. This corresponds with other recent reports that indicate white-collar crime is on the rise in North America with an increase rate of 4.3 percent from 2010 to 2011. While Becker acknowledged that many people operate under a high moral and ethical constraint, it is evident from the above statistics that criminals rationally see that the benefits of their crime outweigh the costs such as the probability of apprehension, conviction, and punishment. Thus, while many people in a position of authority who have the potential to commit white-collar crime may refrain because they hold themselves to a

high moral standard, there are likely many more who decide to gamble. With respect to illegal insider trading, the 2011 PWC global crime survey also supports Becker's theory. This is true because as illegal insider trading practices increase, detection and subsequently the likelihood of prosecution and conviction decrease. Securities regulators try to detect illegal insider trades by looking at "unusual" and often perfectly timed trades to determine when an individual is acting on inside information. However, as the amount of "unusual" and perfectly timed trades become increasingly common, it becomes progressively difficult for regulators to discover criminal activity. Accordingly, as more illegal insider trades occur, the likelihood of detection decreases. Thus, when Becker's model is applied to illegal insider trading, it predicts that as more illegal trades take place, the relative costs (detection multiplied by conviction) decrease and an even higher number of illegal insider trades will result. As mentioned previously, reference to the PWC 2011 crime survey supports this hypothesis. In 2011, illegal insider trading accounted for 6% of global white-collar crime — a 33% increase from 4% in 2009. Moreover, other than cyber crime, illegal insider trading was the only category to account for a bigger percentage of global white-collar crime when comparing the 2009 and 2011 survey results. Accordingly, while a more in-depth statistical analysis is required to confirm the above hypothesis, on the surface, it appears to hold some merit. In sum, Becker's Rational Choice Theory seems to be a valid explanation for why white-collar criminals commit crimes. While Becker may underestimate the value people put on moral behaviour, it is undeniable that when calculating actors weigh the costs and benefits of committing a white-collar criminal act, the high

reward and relatively low risk most definitely factors into their decision. It is also apparent that Becker's model of crime supports the increasing occurrences of illegal insider trading. This is true for the simple reason that with increased illegal trades, detection becomes more difficult and thus the costs involved with illegally trading with inside information decrease. b)

Strain Theory Another theory that attempts to answer the question " why do people commit crime? " is general strain theory. GST or simply " strain theory, " asserts that crime results from conditions and periods where there is pressure to attain a goal or outcome, such as maximizing material gain, that is rendered unattainable because the means of achieving this goal are blocked or unavailable. While this theory is commonly employed to explain non-financial crimes, it also holds considerable explanatory power in relation to the behaviour of white-collar criminals. Several studies in the area of corporate crime have examined the relationships between criminality and pressures to attain a goal (such as profit) in the absence of legitimate means to achieve it and strain theory has proven very useful in the explanation of most types of white-collar and corporate crime. Adjusted to reflect variations in status and the conditions that are fostered within a competitive environment, Steven Box, a British criminologist, saw strain theory as a valuable explanation for white-collar crime. Box saw the modern corporation's goal-seeking structure of profit maximization, combined with uncertain economic conditions, as making a corporation and the actors within it to be inherently criminogenic. As business professionals are faced with economic contractions, an uncertain economic environment, and pressures to cut costs, these individuals may seek out alternative means of

making money. Unfortunately, the alternative means are increasingly illegal in nature. Practices such as tax evasion, illegal insider trading, or fraud are perfect examples. Similarly, Mesner and Rosenfeld, in their book "Crime and the American Dream" have argued that the social structure of the United States involves the intuitional dominance of corporations and cultural values that place emphasis on material gain, individual achievement, competition over cooperation, and an absolute obsession with monetary gains. This institutional structure that places a disproportionate emphasis on advancement and acquiring wealth over the legitimate means to achieve it is thus another source of the problem behind white-collar crime. This is especially true given the current failure rate of business following the economic downturn of the past decade and the simple problem that many people are without the means to achieve the goals they dream of. Additionally, from a statistical perspective, strain theory has proven to be an accurate explanation for white-collar crime. In a 2004 study, strain was shown to be positively correlated with securities violations. Based on the knowledge that securities violators are of high social status but appear to have more employment and liability strains than others in their social bracket, it is logical that they would feel what calls a "fear of falling" in their professional careers. In other words, strain causes them to feel pressure to excel in the workplace by any means necessary, including criminal behavior such as securities violation (illegal insider trading), which is a quick way to relieve the pressure and maintain their status and lifestyle. Similarly, strain also appeared to operate through the negative emotion of financial concerns to increase the likelihood of embezzlement. Since embezzlement directly

involves siphoning or stealing money, it follows that when strain leads to financial concerns, embezzlement serves as a means of alleviating the pressure. In sum, it appears that strain theory is another valuable concept when trying to answer the question " why do people commit white collar crimes? " The inability to acquire profits legitimately is an obvious motive individuals or business to commit white-collar crime and given the current pressure placed on profit maximization it is not surprising that crimes such as illegal insider trading are on the rise. The drive to get and maintain material wealth is an undeniable factor in the decisions made by white-collar criminals and strain theory is a conception of this motive that is well equipped to explain why these decisions are made. PART II — Canadian Insider Trading Analysis Insider Trading — An Economic Analysis The proceeding pages laid down the framework for analyzing insider trading in Canada. Equipped with background knowledge of white-collar crime in general, including its historical origins and its prevalence in Canada, the problem facing securities regulators as a result of illegal insider trading should be clear. The combination of the increasing difficulty in detecting illegal insider trades and the corporate culture emphasis on profit maximization has pushed insider trading to the forefront of white-collar crime research. Unfortunately, Canada is ripe with illegal insider trading. A study performed by Yale University professor Arturo Bris looked at data from more than 4, 500 deals in 52 countries and found that in Canada profits are by far the highest. While not exclusively indicative of illegal insider trading, Bris estimates that insiders in Canada captured 35. 2% of takeover-related trading profits (buying shares in the 60 days preceding a takeover

announcement). To put this in perspective, the first runner-up was Hong Kong at just 3.1% and in the U. S., insiders captured just 0.9% of profits. Bris offers two explanations for the unusually high profits for Canadian insiders: the market is very liquid and corporate ownership is quite concentrated. Liquidity helps make illegal insider trading a profitable strategy because it enables the market to react to corporate news in a timely fashion. Additionally, the heavy concentration of share ownership in Canadian markets makes it easier for insiders to hide their trading. This is because large blocks of stock are traded repeatedly and regulators fail to see these trades as a signal of trading on inside information. Enforcement is another important factor that contributes to Canada's illegal insider trading problem. Canada's regulators do not have a strong record of catching and punishing illegal insider trading. While the charge is extremely difficult to prove, given the amount of "less than moral dealings", such as the Humpty Dumpty situation referred to above, it is unfortunate that there have not been more convictions. Moreover, of particular concern is that the possibility that the current environment is attracting white-collar criminals who want to operate in a relatively safe environment. Canada's markets are relatively liquid and coupled with the lack of illegal insider trading convictions; Canada appears to be a perfect location for insiders to operate. This will be discussed further when "broken window" theory is applied to Canada's current system. In sum, there is an apparent illegal insider trading issue facing Canadian securities regulators. The low prosecution rate, the liquidity of markets, and the high concentration of corporate ownership has made trading with insider information both attractive and relatively easy within Canadian borders. The

following section of the paper will analyze these issues from an economic perspective in an attempt to demonstrate that the current Canadian economic environment is one where major securities crimes, such as illegal insider trading, are becoming increasingly prevalent. a) Definition and Analysis — What is insider trading and why is it regulated? i) What is insider trading? Insider trading arises in securities markets when one party taking part in a transaction possesses nonpublic information that is likely to affect the value of the given security. More formally, insider trading is “ the purchase or sale of a security of a corporation by an insider who has knowledge of confidential information about the corporation that might reasonably be expected to affect materially the value of its securities and that is not known by other security holders or the general public. ” The definition of an “ insider” of a corporation is very broad, and varies depending on the context but it generally includes directors, officers, and significant shareholders of the corporation, as well as others who, may have access to the corporation’s “ inside” information. Traditionally, securities regulators have identified two types of corporate insiders: primary and secondary. Primary insiders are members of a corporation such as executives, board members, officers, and controlling shareholders. Their status gives them access to privileged corporate information and thus a potential trading advantage relative to outsiders. Secondary or “ constructive” insiders are people like lawyers, accountants, investment bankers, and brokers, who may be privy to private information by virtue of a contractual relationship with the firm or its shareholders. To the extent that members of the public receive private information from insiders —

information unavailable to the rest of the investing public — it is possible that relatives or personal and political associates of secondary or primary insiders might also be classified as insiders. In Canada, as well as in many other jurisdictions, trading by insiders is not always illegal; most laws governing insider trading allow insiders to trade in the securities of corporations with which they have a connection, provided they do not possess material confidential information about the corporation that would have an affect on the market price of the respective securities. However, insider trading is prohibited when the insider possesses material confidential information that may be used for his or her benefit when trading in the securities of the corporation. i) Why is it regulated? The regulation of insider trading in Canada is built on concerns relating to fairness and the idea that the law and its enforcers must seek to build confidence in capital markets. On this analysis, investors should feel confident that there is a level playing field and that individuals with access to confidential information will not benefit from their special relationship with an issuer. However, while this is the stance taken by Canadian securities regulators, there is considerable academic debate as to whether or not insider trading should be regulated at all. Proponents of regulation focus on the idea that persons trading in securities markets should not be allowed to profit from information that they have exclusively by virtue of their relationship with a given corporation. In the Report of the Attorney General's Committee on Securities Legislation in Ontario, the committee indicated that, ...it is not improper for an insider to buy or sell securities in his own company. Indeed, it is generally accepted that it is beneficial to a company to have officers and directors purchase

securities in the company as they thereby acquire a direct financial interest in the welfare of the company... However, it is improper for an insider to use confidential information acquired by him by virtue of his position to make profits by trading in the securities of the his company. The ideal securities market should be a free and open market with the prices thereon based upon the fullest possible knowledge of all relevant facts among traders. Any factor which tends to destroy or put into question this concept lessens the confidence of the investing public in the market place and is, therefore , a matter of public concern. We believe that the law should clearly provide that the use by insiders, for their own profit or advantage, of particular information known to them but not available to the general public is wrong and that the law should give appropriate remedies to those aggravated by such misuse. The proper regulation of insider trading is therefore necessary; it represents a major factor in creating stable markets and confidence in the system. In the absence of such regulation, confidential information held by insiders would allow them to gain financially at the expense of other shareholders. While this is the position argued by Canadian securities regulators, many legal scholars who subscribe to an economic approach to analyzing insider trading regulation argue that regulating insider trading is economically undesirable, and that the act of insider trading is victimless. They claim that insider trading based on material nonpublic information benefits investors by more quickly introducing new information into the market. For example, Milton Friedman, a winner of the Nobel Prize in Economics, argues: " You want more insider trading, not less. You want to give the people most likely to have knowledge about deficiencies of the company an incentive to

make the public aware of that. " Friedman did not believe that the trader should be required to make his trade known to the public because the buying or selling pressure itself is information for the market. Another argument made by critics of insider trading regulation is that insider trading is essentially a victimless act. It is a simple transaction in which a willing buyer and a willing seller agree to trade property with no prior contract having been made between the parties to refrain from trading on the basis of asymmetric information. A final and arguably the most compelling argument in favour of insider trading legalization is the fact that trading with " inside" information is perfectly legal in many other types of markets. Accordingly, why should the stock market be any different? The real estate market provides a perfect example: if a geologist knows there is a high likelihood of the discovery of petroleum under a farmer's land, he is legally entitled to make an offer for the land, and buy it without first telling the farmer of the geological data. In this situation, as long as the geologist did not owe the farmer a fiduciary duty (which could have existed if the farmer hired the geologist to inspect the land), there is nothing in contract law that prevents the geologist from purchasing the land. Put simply, while there are many economic arguments against the regulation of insider trading, Canadian securities regulators are focused on two things: ensuring fairness among those who trade in securities and creating building confidence in capital markets. b) Enforcement — Current Enforcement and an application of the " Broken Windows" theory to Enforcement Procedures While Canadian securities legislation is marginally different in every province, the most prominent piece of legislation governing insider trading in Canada is the

Ontario Securities Act (OSA). Accordingly, the OSA insider trading enforcement regulations will be the focus of this analysis. The following section will proceed in two parts. The first part will explain the enforcement measures created by the OSA with respect to insider trading. The second part will apply the “ Broken Windows” theory to the enforcement measures to illustrate the potential for an increase in illegal insider trading.

i) Current Enforcement Procedures

The legislative scheme used to regulate trades by insiders is two pronged. First, the legislation stipulates that under prescribed circumstances, trading by insiders is legal. Specifically, if insiders report trades within a prescribed time period, such trades are permissible provided that they are not based on undisclosed material information. Second, the legislation identifies instances where insider trading is illegal. No insider, or any other individual in a “ special relationship” with the issuer can trade on undisclosed material information. The OSA defines insiders “ as directors and senior officers, parties who control at least 10% of the votes of a company and firms who repurchase their own securities. ” Insiders who wish to trade legally must report their inside trades to the Ontario Securities Commission (OSC) and provide information including: their relationship to the issuer, the transaction date (not settlement date), the (average) price, the quantity of shares traded, and their total ownership after the trade. The OSA requires disclosure within 10 days following an insider trade. Insiders who trade with knowledge of a material fact about a firm that is not generally disclosed are considered to have performed an illegal insider trade. Individuals who trade illegally are liable to their trading counterparty for damages. The damages are calculated by the hypothetical profit from the insider’s purchase or sale

of the shares and subsequent reversal of those trades over the 20 days following the general disclosure of the material information. Insiders are also liable for any gains ascribed to parties they tipped off prior to general disclosure of the material information. In addition to the insider trading regulations set out in the OSA, the Canadian Criminal Code also stipulates restrictions on insider trading. Section 382. 1 of the Criminal Code, (the offences of insider trading and tipping) was introduced in 2004 and it stipulates that insider trading and tipping are indictable offences punishable by a maximum prison term of 10 years. The distinction between the Criminal Code offence of prohibited insider trading and the Ontario Securities Act offence of illegal insider trading is that the criminal offence imports a mens rea requirement that the individual " knowingly used inside information, " whereas in the regulatory context the Crown is only required to prove that the individual was in possession of knowledge that was not generally disclosed. As a result of the difficulty in proving the mens rea element, it is extremely difficult to prosecute illegal insider traders using section 328. 1. ii)

Broken Windows Theory and Insider Trading Enforcement The " Broken Windows" theory argues that a successful strategy for reducing crime is to take a tough stance against minor criminal activity by eliminating signs of unlawful activity such as broken windows or graffiti. The theory claims both petty crime and major crime will be deterred if signs of minor criminal activity are eliminated. On the flip side the " broken-windows theory" holds that if a neighborhood or city does not fix its broken windows, the environment will continue to descend into crime, chaos and more violence. The theory became popular when Mayor Rudy Giuliani adopted the strategy

in New York City after his election in 1993, under the rubric of “ zero tolerance”. As indicated by McNally and Smith in their 2009 study on insider trading in Canada, like New York City in the 1970s, Canadian financial markets are perceived by many to be poorly regulated and crime ridden. This perception was reinforced by the aforementioned Bris study that found Canada to have one of the highest rates of illegal insider trading in the OECD. McNally and Smith analyzed trade data between 1988 and 2006 in an attempt to demonstrate that there were “ broken windows” - a high and sustained rate of error in insider trading reports — within Canadian insider trading enforcement. Their study predicted that the quality of insider trading disclosure would depend, at least partially, on the OSC’s efforts to enforce its reporting rules. To measure enforcement effort, they identified all of the OSC convictions related to insider trading reports by searching the enforcement proceedings of the Commission. They found that convictions of insiders charged with reporting violations were relatively rare until 2003. Prior to 2003 there were convictions only in 1991 and 1999. From 2003 to 2006, enforcement activity increased and there were six convictions. However, relative to approximately 890, 000 insider trading reports filed from 2003 to 2006, six convictions (non-criminal) represent a nominal and insignificant number. With regards to reporting errors, or what McNally and Smith termed “ broken windows”, their study investigated the frequency of four different types: 1) private trades miscoded as public trades; 2) insider trades reported on days when there is no trading (weekends and holidays, or transaction dates when the exchange was open but there was no trading in the security); 3) transaction prices that are outside of the high-low trading range

for the day; and 4) transaction quantities which exceed the daily trading volume for the stock. Their study found that in 2006, over 10% of insider trading reports contained at least one of the above reporting errors. While they noted that this is an improvement from over 33% during the period from 1988 to 1993, the over 10% error rate is still cause for concern. The major worry is that the OSC's apparent lax stance towards filing errors encourages potential rule breakers, thus leading to a higher incidence of more serious infractions such as illegal insider trading.

c) Insider Trading in Canada — Why is Canada a good place to trade with inside information? Three explanations for why Canada is an attractive place for illegal insider trading activity will be discussed in this section of the paper: 1. the high level of liquidity in Canadian markets, 2. the high concentration of corporate ownership in Canadian markets, and 3. the OSC's relatively low level of prosecutions

The Artuo Bris study mentioned above concluded that total takeover gains enjoyed by insiders in Canada who purchased shares in the five to thirty days preceding the public announcement of a takeover was 13.7%, compared with gains of under 1% in the United States, the United Kingdom, countries in Asia, Eastern, Western and Northern Europe, Africa and Latin America. The Canadian profit figure more than doubles to 35.18% when the time frame is extended to 60 days — a figure more than 10 times greater than Hong Kong and Norway, which follow at 3.44% and 2.33%, respectively. In his study, Bris measured illegal insider trading by focusing on abnormal volume and price movements in the days prior to tender offer announcements. One of his primary conclusions is that tougher enforcement doesn't actually affect the incidence of insider trading, but rather it serves to

reduce the amount of profitability. This conclusion is reinforced by the analysis of trades in the U. S. Securities regulations in the U. S. are considered to be the toughest in the world and while the volume of trades between the five to thirty days prior to an announcement was relatively uniform across the 52 countries surveyed, profits enjoyed by insiders in the U. S. were the lowest. Conversely, in Canada, where securities regulation is considered to be relatively lenient, profits enjoyed by insiders were the highest. Intuitively, this makes sense. When Becker's theory of crime is applied to illegal insider trading, it predicts that because the gains are large and the chances of prosecution are low, illegal insider trading should take place regularly. Correspondingly, in the U. S., where insider-trading restrictions are extremely severe, Becker's model would predict that a white-collar criminal could continue to trade with insider information by compensating for the heightened risk of being caught through trading on a smaller scale. Thus, while the likelihood of being prosecuted in the U. S. is relatively higher than it is in Canada, it appears that insiders are compensating for the heightened risk by reducing the volume of stock they trade. Bris offers two primary explanations for the unusually high profits for Canadian insiders: 1) a high level of liquidity in the market and 2) a concentration of corporate ownership. 1) Liquidity Liquidity, which refers to a security's ability to be sold without causing a significant movement in the price and with minimum loss of value, helps make illegal insider trading a profitable strategy because it enables the market to react to corporate news in a timely fashion. Moreover, illegal insider trading is more likely to occur in liquid markets due to the ease at which insiders can move their securities

and liquidate them into cash. 2) Concentration of Corporate Ownership The heavy concentration of share ownership in Canadian markets is another factor that contributes to the apparent high volume of illegal insider trading. The high concentration of share ownership makes it is easier for insiders to hide their trading because large blocks of stock are frequently traded and outsiders and regulators do not perceive this as a signal of trading on inside information. While Bris admits his study does not provide “ a perfect method" for tracking illegal trades — it is impossible to say for certain that all of his findings are 100% illegal insider transactions — it is a good approximation. 3) Low level OSC Prosecutions While Canada’s top securities regulator, the OSC, regularly vows to step up enforcement of insider trading, its efforts have produced only marginal results when compared with the other securities regulators such as the Securities and Exchange Commission (SEC) in the U. S. In 2010, the OSC took only four cases to the courts for all types of security law violations, including illegal insider trading. In 2009, only two cases were mounted and, in 2008, the OSC did not mount any new court cases at all. Given the lack of prosecutions, it is entirely likely that white-collar crimes will increase in the future as criminals realize the chances of prosecution are low. The lack of a national securities regulator is a potential reason why Canada falls behind the U. S. with regards to illegal insider trading prosecutions. The SEC is a national regulator and when charges are laid in the U. S., regulators work in close co-operation with the SEC, the U. S. Justice Department and the Federal Bureau of Investigation. Unfortunately, as a result of the fragmented system of provincial oversight and law enforcement, co-operation does not happen as easily in Canada. d)

Deterrence Methods — Fines and Reputational Penalties An effective enforcement system can deter insider trading either by increasing the probability of detection and conviction, or by raising the severity of the potential sanction. Given the costs of increasing detection and conviction are extremely high, the following will argue that the most efficient way to deter insider trading is to raise the severity of the sanction. Moreover, inside traders, like most white-collar offenders, are believed to be especially amenable to deterrent efforts due to their “ rational and profit-oriented motivation. "As a result, it is likely that would be inside traders will be deterred by an increase in the severity of the potential sanction. The following will discuss the two forms of increasing the severity of the sanction faced by convicted illegal inside traders: 1) increase the monetary penalty (fines) or 2) increase the reputational penalty (shaming). It will be shown that increasing the fine beyond what is currently stated the OSA would have little to no effect on reducing insider trading. However, it is possible that increasing the severity of the reputational penalty may produce a greater deterrence effect. 1) Fines Returning to Becker’s framework, in which criminals weigh the expected costs and benefits of breaking the law, simple mathematics indicates that if the costs of committing the crime are increased (through the increase of fines), criminal behaviour will be respectively deterred. However, while Becker’s model proposes very high fines, if the fines are too high, false convictions would carry too high a cost and competition would be reduced as firms facing these penalties would be crippled. Therefore, to determine the optimal level of fines, it is helpful to analyze the two extremes: a system where fines are zero and a system

where fines are extraordinarily high. One option is to have no fines at all for insider trading, and to rely instead on market forces to impose the costs that keep insiders in line. The market-based approach to antitrust regulation, popularized by Aaron Director of the University of Chicago, holds that antitrust violations, such as insider trading, involves one party cheating another party by using asymmetric information. The theory argues that in time, an insider acting in this way will be punished (possibly by their victims refusing to trade on subsequent offers) meaning that crime will not pay and their actions will be deterred. The problem with this analysis is that while it may hold true in circumstances where the cheater is interacting with repeat victims, due to the ability of insiders to trade with any individual willing to complete a transaction, it is unlikely that an insider would drastically reduce their cheating if the only penalty they faced was the inability to trade with their previous victims. At the other extreme is a spectrum is very high fines. Indeed, Becker's crime calculus might lead to the conclusion that fines should be as draconian as possible—seizing all a wrongdoer's assets, for example. Anything lower reduces the expected cost of criminality, and thus encourages criminal behaviour. However, there are plenty of arguments against ultra-high fines. First, false convictions carry too high a cost and second, fines of this sort could cripple firms and reduce competition. Given that a zero fine policy is unlikely to deter illegal inside trading and ultra-high fines have the potential to decrease competition and unfairly penalize false convictions, a middle ground is likely the most effective option. Not surprisingly, the fines stipulated by the OSA aim to strike a balance between the two extremes. Section 122 (4) of the OSA sets out the fine structure for

illegal insider trading. It stipulates that in addition to any imprisonment imposed, a person or company who is convicted of insider trading is liable to a minimum fine equal to the profit made or the loss avoided by the person or company by reason of the contravention and a maximum fine equal to the greater of \$5 million or an amount equal to triple the amount of the profit made or the loss avoided by the person or company by reason of the contravention. Thus, the OSA gives judges the ability to determine the appropriate penalty based on the severity of the criminal act. This is arguably a sufficient middle ground as further increases fines would be unlikely to have an equal deterrence effect because after a certain level — one could argue \$5 million — the incremental increases are insignificant from the perspective of the insider.

2) Reputational Penalties — “ Shaming”

In recent years, public embarrassment has returned as a potential means of punishment. With increasing frequency, judges are using bumper stickers, billboards, t-shirts, and even community access television to publicize a defendant’s transgressions. Moreover, there are many highly respected legal academics who endorse the “ shame” approach for white-collar crime. They argue that modern versions of the dunce cap, rather than shackles, best fit the corporate criminal. The influential Dan Kahan, one of shaming’s biggest supporters, has proposed that it become a regular part of the sentencing process and replace incarceration as the penalty for many “ white collar” offenders under the securities regulation in the U. S. According to Kahan, shaming is more efficient than incarceration because it provides the same level of deterrence while requiring less of society’s resources. Kahan and his followers prefer shaming over incarceration due to its efficiency. First, Kahan

explains that “ white-collar offenders do not pose physical threats to others; the threat they pose consists of their ability to gain the confidence of a victim and then cheat him. ” If the federal government effectively shames the “ white collar” offender, then “ everyone knows or can easily discover that the offender is a bad type. ” Thus, the offender is effectively incapacitated because the general public will avoid him and the effect is similar to the situation where the offender is surrounded by bars. In addition, traditional sentencing options such as imprisonment carry much higher societal costs than shaming. It costs relatively nothing to publicize a list of wrongdoers in the newspaper when compared to the cost of incarceration. Finally, the harm to an offender’s reputation is also why shaming is more effective than monetary fines. Even though a defendant frequently can pay fines and ultimately continue his business, “ shaming directly destroys an asset that the fine cannot destroy — the offender’s reputation. ” In other words, a publicly destroyed reputation puts a white-collar criminal out of business as potential victims know to steer clear of the offender and his schemes. While Kahan’s theory sounds promising, there is one major problem. In his efforts to introduce shaming into the sentencing process, Kahan ignores the shame that already exists in the current criminal justice system. When a white-collar criminal is sent to jail, shame is inherent in the penalty. However, given the difficulty of convicting insider traders in Canada on the criminal standard, shaming for civil liability infractions is a viable strategy. Thus, it would be beneficial for Canadian securities regulators to build shaming mechanisms into the penalties involved with insider trading. It is a relatively inexpensive deterrence method and one that could prove very

effective. Conclusion White collar crime did not begin with Xenothemis and Hegestratos, nor will it end with Bernied Madoff and Stan Grmovsek. It has been part of society since the dawn of business and will remain so. The current economic climate has created an atmosphere where pressure to increase profits has resulted in vast amounts of white-collar crime. White collar criminals continually innovate so as to avoid detection and as a result, an accurate valuation of the true cost of white collar crime is difficult to determine. Regardless, the annual costs to society are undoubtedly hundreds of billions of dollars. The economic analysis of white-collar crime on the previous pages has provided insight into both the motivation of criminals and the insider trading problem facing Canadian securities regulators. The combined effect of high market liquidity, high concentration of security ownership, and relatively relaxed enforcement practices has been to create an epidemic of insider trading in Canada. Moreover, given the over 10% error rate in reporting insider trades, or what McNally and Smith refer to as “broken windows”, it is not unforeseeable that the problem could get worse. While increasing fines is unlikely to deter further criminal actions, it is possible that building shame mechanisms into the OSA could have the effect of decreasing white-collar crime. In September 2002, Canadian securities regulators hired fraud expert Malcolm Sparrow from Harvard to help them create the Insider Trading Task Force to look at the extent of the insider-trading problem in Canadian capital markets. The task force recently reported: Due to data limitations, it is currently very difficult to establish accurately the extent of insider trading, much less illegal insider trading, that occurs on Canadian markets. Nevertheless, academic research consistently

evidences trading on inside information on markets around the world. There is no reason to believe that Canadian markets would not also be victimized by these activities. With increased ease of access to offshore trading and the continued development of the options and single stock futures markets, illegal insider trading threatens to become more prevalent and profitable over time without strategies to mitigate the risk. Unfortunately, that report was released over 10 years ago and while there has been significant improvement in combatting insider trading, there is still much work to be done. ----- [1]. This occurs for the simple reason that fraud is often initialized through an existing relationship of trust. It follows that fear of corporate crime upsets the " allocative efficiencies" of markets through undermining profit, distorting share values and other communicative signals, thereby limiting the willingness of corporations, banks, and individual investors to move capital around in the ways that well-functioning markets need to survive. Further, in an era of increasing investor ethical sophistication, white-collar crime and unethical business practices more generally undermine profits and productivity through simply turning investors off of the goods and services offered by companies that are thought to engage in these practices. (Sliter 2007: 16; see also: Schnatterly 2004: 867). [2]. He was accepting ... [3]. Sutherland's address... [4]. Simple fraud schemes committed by relatively low class people is also a form of white collar crime but it doesn't fit within Sutherland's definition. [5]. Kaliski, Burton S. " Crime and Fraud." Encyclopedia of Business and Finance. New York: Macmillan Reference USA, 2001. 216-17. Print. [6]. It was not evident that either of the men were persons of " respectability and high

social status. " [7]. Formed in 1934, the U. S. Securities and Exchange Commission was the first formal security regulator. [8]. Credit Mobilier was the construction company responsible for building the Union Pacific Railroad. [9]. Union Pacific was the operator of the rail system being constructed. [10]. The family also secretly used millions in corporate funds for personal fun. [11]. While both Enron and Madoff were discovered in 2001 and 2008 respectively, their fraudulent operations both took place during the 1990s. [12]. <http://finance.yahoo.com/news/gallup-finds-perception-business-corruption-172400103.html> [13]. Ibid. [14]. PWC Survey [15]. ibid [16]. Canadian Security Administrators. (2007). 2007 Canadian Securities Administrators Investor Study: Understanding the Social Impact of Investment Fraud. Executive summary available online at: www.csa-acvm.ca accessed 16 January 2009. [17]. (CSA 2007: 5) [18]. (see also: Levi and Pithouse 1992; Shichor, Doocy and Geis 1996; Shover, Fox and Mills 1994). [19]. (Hetzer 2006: 402-403; Winslow 1999) [20]. <http://fairwhistleblower.ca/content/system-rotten> [21]. " Humpty Dumpty heads gain from failed bid, " National Post, November 20, 2002. [22]. Combating White Collar Crime in Canada: Serving Victim Needs and Market Integrity [23]. <http://encyclo.findlaw.com/0710book.pdf> [24]. <http://www.nytimes.com/2004/07/17/business/martha-stewart-s-sentence-overview-5-months-jail-stewart-vows-ll-be-back.html?pagewanted=all&src=pm> [25]. <http://www.kpmg.com/ch/en/library/mediareleases/pages/forensic-fraud-barometer-2011.aspx> [26]. <http://www.marketwire.com/press-release/gallup-finds-perception-business-corruption-widespread-as-white-collar-crimes-increase-1657538.htm> [27]. <http://books.google.com> <https://assignbuster.com/the-economics-of-white-collar-crime/>

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Other insiders include officers and directors of affiliates, as well as employees of commercial/investment banks and employees of target or bidder firms within six months of a takeover. (OSA s. 1(1)) [49]. (OSA, Section 107(2)) [50]. OSA s. 1 (1): “ material fact”, when used in relation to securities issued or proposed to be issued, means a fact that would reasonably be expected to have a significant effect on the market price or value of the securities. [51]. (OSA, Section 134(1)) [52]. (OSA, Section 134(6)) [53]. (OSA, Section 134(2.)) [54]. William McNally and Brian Smith: Bay Street’s Broken Windows: Negligence in Insider Disclosure and Enforcement [55]. 2003 marked the implementation date of SEDI which made insider trading easier to trace. [56]. Canada Post - <http://investorvoice.ca/PI/405.htm> [57]. Maug, Ernst, 2002, Insider trading legislation and corporate governance, *European Economic Review* 46, 1569-1597. [58]. Globe article on Bris [59]. <http://www.theglobeandmail.com/report-on-business/small-business/sb-growth/a-world-of-difference-on-insider-trading-prosecutions/article1360483/> [60]. Becker (Crime and punishment)