Bill C-74 Remediation Agreements

Comments to the Standing Senate Committee on Legal and Constitutional Affairs

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Thank you for giving me an opportunity to speak. Let me first introduce myself.

- Professor of Finance and Business Economics, Rotman School of Management, University of Toronto; Cross-appointed, Associate Professor Faculty of Law, U of T
- My reasons for being here are tied to some activities I am involved with (a) Director, Capital Markets Institute, University of Toronto; (b)Academic Director, Directors' Education Program since 2004, and (c) I conduct research and Teaching in area of Corporate Governance, particular expertise in corporate fraud, whistleblowing.

My opening remarks will focus on the following points, which I will elaborate upon :

1. Canada would be better off with less corporate wrongdoing
2. Current system far from ideal to deter wrongdoing
3. Alternative reforms, on surface appealing, such as increasing resources and Sanctions for regulators, will not ‘move the dial’
4. Remediation Agreements, if properly constructed, both lead to more detection of wrongdoing, *and* lower level of wrongdoing
5. More clarity on publication, penalties, and sunset clauses would increase likelihood Remediation Agreement regime is an improvement, and address reasonable potential concerns.

1) Canada would be better off with less corporate wrongdoing

- Wrongdoing - corporate fraud, foreign corruption, anti-competitive behavior - costs not only firms involved, but has cost on all the firms in the economy.
- Market doesn't know if your firm is a bad actor, forms expectation assuming a % of firms will be bad actors. The higher this %, the more expensive for firms to fund their investment projects with money from external investors, and lower new firm formation.

2) Current system far from ideal to deter wrongdoing

- When **expected costs** of wrongdoing are large, corporate imperative to devote resources and create processes to discourage.
- But under the current regime, the expected costs are low because of excessive focus on Sanctions
- Expected costs are **product** of **Sanctions** multiplied by **Expected likelihood of detection and successful prosecution of fraud.** And **Reputational sanctions** important as well as **government sanctions**.

3) Data and theory show why Government Sanctions plays a ‘supporting actor’ role rather than a leading actor role in deterring wrongdoing in Canada

- If we focus on foreign corrupt practices, the data is clear: expected likelihood is negligible and trivial reputational sanctions with so few cases.
  - 4 successfully prosecuted cases for firms since 1999, equalling 0.2 cases in any given year. For one of the approximate 300 large traded firms that translates into a 0.07% per year chance of a case.
- The data shows that in other jurisdictions this can be more successful, with the US being a leading example. Through 2013, 143 cases. Still not huge likelihood of enforcement, 6% for likely bribe payers according to credible research.
- Simple cost-benefit analysis aligns with the data. Even if internally learn about wrongdoing, discouraged from revealing. No obligation to report a crime. If you do, you will face criminal sanctions, and your firm will certainly suffer (e.g. loss of contracts). So, what board members tell me, let the person go but don’t publicize it. The corporate culture of that firm erodes, as those that know that is going on see the guilty party being paid to leave. And we get ‘pass the trash’ with the wrongdoer going to another firm.

4) A possible alternative that sounds attractive– increase resources/capability of external gov't detectors - isn't going to work by itself

- This claim comes from my prior research on fraud in the United States, (published in the *Journal of Finance*, with co-authors from University of Chicago and Berkeley,) We found that even in US where have more resourced national securities regulators in addition to other government agencies, when it comes to corporate fraud, government regulators with specific mandate to uncover fraud account for a trivial % of those frauds. Just 7% identified by SEC for example.
- We offered a conjecture why failure of external detectors – that the information is complex, inherently hard to identify and naturally only possessed by a small number of parties, who have every reason to conceal it.
- And we conjectured that changing the incentives of those with the greatest access to that information because of their corporate position– making it less costly to reveal, and potentially giving them an upside - could bring out more information.
- And we provided evidence in support. Whistleblowing changes in US in Dodd-Frank, and in Ontario with OSC office of the whistleblower, builds on the case we made.
- Article was about corporate fraud. When it comes to foreign corrupt practices the complexity and difficulty of outsiders getting credible information that can be used to secure criminal convictions is that much harder. **Finding a way to unlock internal information is key**.

5) Remediation Agreements, if done right, both lead to more detection of wrongdoing, *and* lower level of wrongdoing

- **Why more detection**? Because Remediation Agreement changes incentives for actors inside the firm to bring information to light. Both corporate actors and whistleblowers. Reduce costs for firm.
- **Why lower level of wrongdoing**? Remediation Agreements lower the probability of Sanctions *a little*, while if done right raise probability of detection *a lot*, and detection creates reputational penalties, producing greater expected penalties. This leads to more corporate resources devoted to processes to solve the problem in the first place. It helps those actors who seek to do the right thing.

One way to summarize tradeoff in move to remediation agreements

Current: 0.2 firms/year face large sanction (say 100)=2

versus

Remediation agreement 2 firms/year (<1% of traded firms) face smaller sanction (say 10)=20

The point to take away 20>>2 big potential benefits

It is a big mistake just to focus on the potential decline in sanctions even if they are big (e.g. from 100 to 10)

Need to also focus on the increase in likelihood of detection, and the remaining penalty.

So long as these are large enough, this clearly makes sense. 20>>2.

And with 20, corporate actors develop better processes.

6) My suggestions for more clarity are to ensure the math adds up (which creates public confidence): ensure more detection and ensure remaining penalty remains high enough

- **Publication requirement –**
  - Clause giving opportunity not to publish huge potential to be abused. Not publicizing weakens penalties (no reputational Sanction), makes it harder to improve corporate culture, raises greater scope for abuse.
  - **Publication required to ensure public confidence that tradeoff is positive -** that enough more cases, and that penalty large enough, so that this is welfare enhancing.
- **Penalties should be the norm, and sufficiently large –**
  - Found language vague regarding expected financial penalties. Norm in Canada is not of substantial penalties, fueling public concern of potential abuse. Whatever could be done to require penalties, and penalties be sufficiently large would be helpful to make tradeoff work. Repeat wrongdoers should face different sanctions and access to this opportunity.
- **Sunset provision, with option then to renew–**
  - Sunset would make even more clear value of publicizing cases and that penalties sufficiently large, as without this should not get renewal.
- **These comments are reinforced based on experience with no-settlement provisions with OSC and Fintrac's Administrative Monetary Penalties Program.**
- **I also have some additional suggestions for consideration happy to touch on in questions.**

Additions worth consideration?

- Whistleblower rewards tied to information linked to DPA or other ?
- Would be more powerful if was tied to whistleblower incentives
  - Decline in penalty for firm may make more whistleblowers willing to come forward. In fact, this may be an important reason for more detection.
  - If whistleblowers provide information that results in DPA with financial payout, then whistleblowers entitled to a percentage of the payout

Importance of publication, penalties, and sunset reinforced by other ‘similar’ reforms

no-settlement provision with OSC

- Introduced in 2014, at end of 2017, 10 finalized cases, $358 m aggregate returned to investors, helps to fund investor protection office.
- Seems to work, judged by frequency of cases.
- Also some concerns
  - Questions about level of disclosure surrounding misdeeds

Fintrac Administrative Monetary Penalties Program, since 2009

- Courts have put in limbo, given lack of clarity over how penalties will be determined.
- Also concerns about lack of disclosure. April 2016 case of Canadian bank and AML and fine where revealed case, but no name. Undermined confidence.

Whistleblowing evidence shows how changes in incentives that bring new info to light help with penalties, changing calculus.

Research in US by Andrew Call and co-authors

- Shows enforcement actions supported by whistleblowers produce:
  - More significant penalties (15x firm penalties, 10x other penalties)
  - Longer criminal sentences (50% longer)
  - Lower time for discovery

- Wilde (2017, The Accounting Review) – "…firms subject to whistleblowing allegations exhibit significant decreases in financial reporting and tax aggressiveness."
- •Deterrence effect persists for about two years

Expect as much as in US?

- No
  - No administrative process whereby provincial securities regulators can get involved, as is the case with SEC and FCPA
  - SEC may have information that is useful and skill sets to follow up. Threat of restricting trading practices or other penalties a powerful sanction.
  - Securities regulators can get involved now.

Other reporting

- Fintrac reporting on involvement in frauds and anti money laundering
- Lack of fulsome disclosure caused more problems than it helped.
- Identifying a firm, but not naming firms, besmirched all in sector. Undermined confidence. Information ultimately revealed.