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Research Study

Towards Effective Balance Between Investors and Issuers in Securities Regulation

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August 1, 2006

Commissioned by the
Task Force to Modernize Securities Legislation in Canada

Evolving Investor Protection

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Acknowledgments

Thanks to Justin Connidis, Paul Halpern, Doug Harris and Poonam Puri for their valuable comments. Thanks to Keir Hunt for early research assistance and Amy Murakami for her diligence in reviewing the paper in its final stages.

1. Executive Summary

This study examines the current balance in securities regulation between two crucial stakeholders: investors and issuers. It observes that capital market regulation is voluminous, negatively impacting market efficiency and investor interests. This study also examines the importance of maintaining the competitiveness of Canadian capital markets as a distinct objective and proposes that this goal be enshrined in the regulation itself. Finally, recognizing that balance per se may be impossible to achieve and certainly to maintain, this study proposes that securities regulators employ a series of principles in order to work towards effective balance between issuers and investors. The main conclusions of the study are:

Regulatory Approach:

- Maintaining Canada's competitiveness within the global economy requires securities regulation that is harmonized (but not necessarily uniform) with other jurisdictions. That said, Canadian securities regulation should not as a matter of course emulate or follow U.S. regulation. While harmonization with the law of other jurisdictions should, broadly speaking, be an objective of securities legislation, the distinctive features of Canadian capital markets suggest that initiatives unique to Canada are preferable in certain instances. The distinctive characteristics that need to be considered in devising regulation include: size and type of issuer, ownership structures, investor sophistication and type of security.

- Two-tiered regulation that distinguishes between large, seasoned issuers with highly liquid stock (first-tier) and small- to mid-cap issuers with less liquid stock (second-tier) would strike a useful balance between the needs of issuers and investors. This is not to say that regulation of second-tier issuers should be more lax but rather that the concerns of issuers of different sizes, as well as those of investors who invest in these firms, vary and should be taken into account in the regulation. The balance between investor protection and market efficiency differs depending on factors such as the size of issuer, since the burden of a given legislative or regulatory initiative may be insignificant for larger issuers but material for smaller ones.

- Cost-benefit analyses are often used to indicate how and why a particular regulatory choice. However, these analyses are often inadequate and lead to vague results because of difficulties in quantification of both costs and benefits. This report favours regulatory impact assessment, a type of analysis that can include cost-benefit analyses but also includes risk assessment more broadly.

- As long as disclosure of information is the cornerstone of securities regulation, plain language should, at the very least, be a recommended component of all primary and secondary market disclosure documents. The fact that many investors invest through a dealer and that Canada has a preponderance of controlling and institutional (i.e. sophisticated) shareholders does not negate the necessity for plain language. Plain language can improve the quality of disclosure, which should be a primary focus of securities regulatory authorities.

Public Offerings:

- A more formalized process for reviewing and monitoring issuers' continuous disclosure should be in place prior to the adoption of more liberalized offering rules, such as the U.S. well-known seasoned issuer rule.

- Market certainty requires that issuers and investors have a firm idea of the extent to which continuous disclosure will be monitored, and particularly, the legal consequences of inadequate continuous disclosure. Unless legal consequences exist, there will be little deterrent effect to curb inadequate and faulty disclosure.

Exempt Market:

- The closed system has proven over time to be one of the least comprehensible aspects of securities regulation, consisting of patchwork, un-harmonized law. The more securities regulation relies on continuous disclosure - rather than the prospectus - as the cornerstone of disclosure obligations, the more outmoded the closed system becomes. The extent of disclosure, both primary and secondary, available in regards to the issuer should be the touchstone of access to the private markets rather than whether an issuer has filed a prospectus or whether an investor has waited the requisite restricted periods.

- For example, in cases where a seasoned issuer has filed quarterly MD&A, an AIF and other continuous disclosure documents, and this issuer completes an exempt distribution of securities, current resale restrictions should not apply to the securities issued under the exemption. It may be useful, as a starting point, to sunset this legislative change to determine whether investor protection concerns arise (or become apparent) when dispensing with resale restrictions in this circumstance.

- Where possible, exemptions should be based on a "sophistication of the investor" rationale, as opposed to a "relationship to the issuer" rationale.

- Blanket orders should be reinstated as a means for issuers to gain permission to complete transactions that are not specifically contemplated in the regulation

Corporate Governance:

- The question of whether we have too much or not enough corporate governance regulation has become pressing given extensive disclosure requirements and the implementation of audit committee composition and financial statement certification rules. The actual costs of this corporate governance regulation have not been determined, and in fact may not have been foreseen prior to the implementation of corporate governance rules in 2004. Does Canada's corporate governance regime, which is heavy on disclosure and compliance obligations generally, provide benefits proportionate to its costs? To answer these questions, it is necessary to conduct empirical tests, including a regulatory impact assessment, on these corporate governance laws.

- The response of regulators to events that shake investor confidence (such as the fall of Enron) has generally been to implement more regulation. However, it is important for new regulatory initiatives to be supported by formalized cost-benefit analysis or regulatory impact assessment: eventually, the marginal benefit of regulation will exceed its marginal cost. Ever-increasing disclosures have an inverse relationship with the utility of such disclosures.

- A best practices approach to corporate governance is appropriate because it allows issuers to choose which particular corporate governance structure to adopt. By having aspects of the Canadian regime built on a voluntary code, the regime utilizes market-based incentives for compliance. Empirical evidence relating to the effect of the *Sarbanes-Oxley Act* on non cross-listed firms supports the existence of such market-based incentives.

- Securities regulators should aim, through the use of empirical analyses, to understand where market-based incentives for compliance with legislative initiatives exist and structure the regulatory regime accordingly. This would contribute to reducing the regulatory burden in the corporate governance area, as well as in other categories of regulation.

Take-Over Bids:

- The law relating to defensive tactics in Canada is appropriately aimed at providing shareholders with the choice of whether to accept or reject hostile take-over bids. In particular, the law surrounding the poison pill seeks to ensure that the target board has time to search for additional offers or other value-enhancing alternatives. It is appropriate that the target shareholders, not the board alone, are the focus of the law relating to defensive tactics, especially in capital markets where there is a high degree of concentration of ownership.

- Recent case law has cast ambiguity over current law relating to duties in a take-over bid. Specifically, after the *Wise* decision, it is not clear that the duty of the target board in a take-over bid is to maximize shareholder value. Securities regulators should consider whether the target board's duty is indeed to maximize shareholder value and if so, how existing case law is to be reconciled with this duty.

Competitive Stance:

- The mandate of securities regulators should include a commitment to maintaining the competitiveness of Canadian capital markets within the global economy. Canadian issuers cannot be expected to flourish in a global economy if these issuers do not have competitive local capital markets to access, when necessary.

2. Summary of Recommendations

<u>Recommendation #1:</u> Securities regulation in Canada should take into account the distinctive aspects of Canada's capital markets, such as the preponderance of small- to mid-cap issuers; ownership structures typical in Canadian capital markets; the preponderance of institutional and controlling shareholders; and the types of securities issued.

<u>Recommendation #2:</u> Consideration should be given to whether an access-equals-delivery model should be more broadly implemented in Canada. With the existence of SEDAR and SEDI, it stands to reason that the "next step" in the evolution of our disclosure-based system is to adopt a more extensive access-equals-delivery model.

<u>Recommendation #3:</u> In light of the different ways in which "efficiency" can be defined, it is necessary for securities regulators to identify the concept(s) of efficiency that are driving a particular legislative initiative and the ways in which that particular type of efficiency is being achieved under the proposed initiative. Doing so will aid in understanding whether the proposed regulation achieves an appropriate balance between efficiency and investor protection.

<u>Recommendation #4:</u> As a general practice prior to implementing regulation, securities regulators should commission or undertake empirical studies in order to assess the costs, benefits and risks of the initiative, and to determine whether the regulation will accomplish the intended results.

<u>Recommendation #5:</u> Where it is not possible to conduct statistical analyses or cost benefit analysis regarding a particular legislative initiative, securities regulators should disclose precisely why it was not feasible to do so.

<u>Recommendation #6:</u> Regulation for which there is little or no empirical support should be sunsetted for a limited period of time, after which regulators will conduct a revised and formal cost-benefit analysis or regulatory impact assessment. If appropriate, such an examination should include the use of statistical analyses to determine whether the regulation has had a positive impact on affected parties and whether the costs of such regulation are justified.

<u>Recommendation #7:</u> If cost-benefit analyses are to remain a central part of analyzing regulatory initiatives, the basis on which these analyses are occurring must be formalized and made more

explicit as is the practice at the Financial Services Authority. Specifically, publicly available guidance that provides formalized criteria on which regulators assess costs and benefits in any given case is necessary.

Recommendation #8: **Because of its focus on risk assessment in addition to costs and benefits, regulatory impact assessments should be adopted as a means of evaluating regulatory initiatives.**

Recommendation #9: **Prior to or concurrently with liberalizing rules relating to public offerings, securities regulators should implement a more formalized and national system of continuous disclosure review and make this system of review known to the public. Without certainty in this area, the deterrent mechanism that may serve to prevent inadequate disclosure cannot function effectively. This increased monitoring may include devolving responsibility for monitoring issuers' disclosure to self-regulatory organizations (particularly RS Inc.) or stock exchanges.**

Recommendation #10: **Restricted periods should not apply to seasoned issuers that have complied with their continuous disclosure obligations, and have filed AIFs and quarterly MD&A over a certain period of time (such as two years). If adopted, this change in the law should be sunsetted in order to determine whether investor protection concerns, particularly the amount of disclosure available to first purchasers of securities regarding the restricted securities, arise.**

Recommendation #11: **Securities regulators should undertake an empirical review of the extent to which investors, both retail and institutional, review issuers' disclosure and the bases on which these investors make decisions. This review should include conducting a statistical survey of both retail and institutional investors, and may also consist of determining the number of beneficial holders that have requested to receive disclosure documents.**

Recommendation #12: **Exemptions from the prospectus requirements should, where possible, be based on a sophistication of the investor rationale as opposed to the assumption that certain individuals with a relationship to the issuer will be protected because of that relationship. Exemptions should strive to be harmonized, easy to understand and easy to access.**

Recommendation #13: **In the interests of harmonization, exemptions that are acceptable in two-thirds of the provinces should be adopted as a matter of course in the remaining provinces.**

Recommendation #14: **Blanket orders should be reinstated as a means for issuers to gain permission to complete transactions that are not specifically contemplated in the regulation. Such orders should include permissions to raise capital in the exempt market.**

Recommendation #15: **It is necessary to discern the extent to which Canada's corporate governance regime, which contains extensive disclosure and compliance obligations, is indeed important and beneficial for investors/shareholders. To this end, further studies should be commissioned by securities regulators with regards to whether there is a relationship between firm performance and particular governance mechanisms in place in Canada.**

Recommendation #16: Justification of corporate governance laws should be based on regulatory impact assessments or formal cost-benefit analyses that outline the benefits and risks of the regulation as well as potential alternatives.

Recommendation #17: **Regulators should be cognizant of market-based incentives that encourage compliance with best practice regimes or voluntary standards and utilize market-based incentives when feasible in the implementation of corporate governance regulation.**

Recommendation #18: **Given the role of disclosure in decreasing information asymmetries, mandatory disclosure should be a central component in an otherwise voluntary corporate governance regime.**

Recommendation #19: **This report endorses the principle of plain language. Further study is warranted on the appropriate division of responsibilities in ensuring that disclosure documents are readable, as it is not clear that issuers alone should bear this responsibility. A general policy statement - rather than a rule - should be issued setting forth principles for plain language in all disclosure documents.**

Recommendation #20: **In drafting legislation, such as rules, policy statements, and comments to market participants, regulators should adopt the practice of writing in plain language.**

<u>Recommendation #21:</u> In light of recent case law, securities regulators should consider whether the duty of the target board in a take-over bid is to maximize shareholder value and if so, how existing case law is to be reconciled with this duty.

<u>Recommendation #22:</u> Regulatory consideration should be accorded to the 15% limitation in the private agreement exemption, to determine whether this is the appropriate ceiling and whether it should be higher or lower. Greater transparency regarding the rationales underlying the exemption is warranted, especially with regards to the extent to which a principle of equality is enshrined therein.

<u>Recommendation #23:</u> The mandate of securities regulators should include a commitment to maintaining the competitiveness of Canadian capital markets with global markets.

3. Introduction

Globally, Canada's macroeconomic performance has been described as enviable, reflecting a sound institutional and policy framework (IMF, 2004). Clearly law, and particularly the law regulating capital markets, is one factor that underpins this comprehensive framework. Generally speaking, the regulatory framework is strong and not in need of fundamental reform. The question addressed here is whether capital markets regulation is *too* comprehensive: as the regulation becomes increasingly voluminous, does it achieve its objectives and maintain an appropriate balance among them? Clearly, if the regulation is excessive, issuers and investors are impacted. But the impact is also felt more generally on Canada's economic well-being and competitiveness.

At present, the regulation consists of complex and dense rules that dictate the behaviour of issuers and other market participants. The multifaceted objective of the regulation is to protect investors from "unfair, improper or fraudulent practices", and to foster "fair and efficient capital markets and confidence in capital markets."[1] The purpose of this report is to analyze whether securities regulation effectively balances these objectives. In particular, the Task Force to Modernize Securities Legislation in Canada requested an analysis of whether a polarization between investor-friendly and issuer-friendly regulation exists; whether one complements or impedes the other; and whether the securities regulatory system can be improved.[2] The Task Force also requested an examination of the balance of these interests and the effect of the regulation on the global competitiveness of Canada's capital markets (IDA, 2005a).

Few will question the point that laws aimed at protecting investors underpin confidence in the capital markets. However, is it possible that there is an imbalance between regulation aimed at investor protection on the one hand, and market efficiency on the other, that manifests itself in too much regulation overall? Securities regulation has certainly proliferated in recent years, especially since the implementation of rule-making in Ontario. This expanding body of law has led Ontario Securities Commission (OSC) Chair David Wilson to state, "[f]ostering confidence depends on striking the right balance and carefully avoiding excessive, unproductive burdens on market participants" (Langton, 2006). It has also led the British Columbia Securities Commission (BCSC) to draft and propose a new securities act that attempts to regulate on the basis of "a streamlined and simplified rulebook, written in plain

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[1] Securities Act, R.S.O. 1990, c. S- 5. [hereinafter Securities Act (Ontario)].
[2] Research question posed by Task Force reproduced in full at Appendix 1.

language. It places greater emphasis on establishing clear principles and replaces detailed and prescriptive rules with an outcomes-based approach…" (BCSC, 2004).[3]

Canadian capital markets comprise but 2-3% of the world's capital markets. Relative to other capital markets and particularly those in the United States, Canadian markets are both shallow and highly concentrated. Given the size of Canadian capital markets, the number of issuers that access them and the amount of capital raised in them, it is not inaccurate to characterize securities regulation as voluminous. It is imperative that securities regulation encourage domestic *and* foreign issuers to choose Canada as a market where they will raise capital. Thus, achieving balance in securities regulation is a matter of protecting investors and maintaining efficient markets, as well as enhancing the competitiveness of Canadian capital markets. Without question, this is a difficult balance to strike and, because capital markets are not static, it will never be certain whether the balance has in fact been reached or maintained.

Analyzing the interests of stakeholders depends to a significant degree on the definitions attached to terms such as "efficiency" and "investor protection", and the context in which they are being used. For example, the term "efficiency" can refer to informational efficiency, allocational efficiency or Pareto optimality. Depending on the conception of efficiency being used, the objectives of securities regulation may or may not conflict. As will be discussed, it is incumbent upon securities regulators in their notices accompanying a new regulatory initiative to set forth the conception of efficiency that they are employing and the corresponding sense in which the initiative balances investors' concerns with issuers' interests.

This report examines four areas of substantive law – public offerings, the exempt market, corporate governance and take-over bids – and assesses the current balance in these areas of law between investor and issuer interests. Certain reforms are suggested. For example, the report argues that in the law relating to public offerings, a more comprehensive system for monitoring issuers' disclosure is required before further liberalizing the regulatory regime. With regards to the regulation of the exempt market, in certain cases, restricted periods are unnecessary. In corporate governance regulation, the utility of ever-increasing disclosures must be questioned, and issuers' incentives to adopt governance practices voluntarily acknowledged. Finally, in take-over bid regulation, directors' duties in the context of a take-over bid require clarification.

This analysis suggests that the appropriate balance between investor protection and market efficiency cannot be analyzed on the level of substantive law alone. The issue of the appropriate regulatory balance

[3] The B.C. government has delayed implementation of the B.C. Model.

is also one of dispensing the law. For example, to what extent are violations of securities regulation enforced? To what extent is an issuer's continuous disclosure monitored? To what extent are applications for exemption orders accepted or denied? This report highlights instances in which a particular regulatory approach can assist in reaching an effective balance among stakeholders. However, it does not examine the broad issue of enforcement, as this particular issue is not part of this report's mandate. Rather, enforcement is discussed in other reports commissioned by the Task Force (e.g. Condon and Puri, 2006).

The report also emphasizes the importance of empirical analyses in formulating and justifying securities regulation. The implementation of regulation without supporting empirical evidence is a weakness that pervades securities regulation in Canada generally. Without the benefit of empirical evidence, it is impossible to know whether proposed regulation is necessary and, if so, whether it will be effective in achieving the desired results. As a general practice before implementing regulation, securities regulators should solicit, commission or conduct empirical studies with the objective of enabling regulators to assess the costs, benefits, risks and overall impact of the regulation.

Part 4 sets the background for this paper by identifying distinctive features of the Canadian economy that must be taken into account when evaluating the role of strong securities law in this country. Part 5 examines the underlying concepts of efficiency and methodologies that are used to assess whether balance has been achieved in securities regulation. Part 6 examines securities regulation in the fours areas noted above (the public offering process, the exempt market, corporate governance and take-over bids). The fact that the laws are not completely uniform across the country adds a further wrinkle in the process of drawing conclusions about "Canadian securities regulation" as a whole. While the law is substantially similar across the various jurisdictions, the lack of uniformity in law poses efficiency concerns that are not within the mandate of this report to discuss, but which have been addressed elsewhere (Anand and Klein, 2005). Part 7 examines the issue of the competitiveness of Canadian capital markets in the context of maintaining a balance between issuers' and investors' interests. Part 8 provides concluding remarks as well as principles that should drive the process of weighing investor versus issuer interests in securities regulation.

4. Characteristics of Canadian Capital Markets

One of the enduring aspects of the Kimber Report is its effort to balance, over the range of issues it examines, the interests of issuers on the one hand and investors on the other.[4] In the 40 years since the Kimber Report was written, however, the balancing act has become more complex. The law is more voluminous, capital markets stakeholders are more diverse, the types of securities offered in the markets have expanded and secondary market transactions have overtaken primary market transactions as the principal means by which securities change hands. These developments, and the distinctive aspects of Canadian capital markets, are described below.

i. Self-Regulation

One of the biggest shifts is the growth of intermediaries as a significant stakeholder in secondary market transactions. Dealers have become indispensable players in securities transactions, and their role has evolved significantly. Some dealers provide no investment advice and charge a fee for trade execution services only. Others offer advice together with their trading services in a so-called "wrap account". The IDA estimates that its 190 investment dealer firms employ more than 39,000 people in Canada and abroad and that these individuals account for over 97% of the industry's revenue and capital (IDA, 2006).

Just as there has been a growth in the number of individual dealers, there has been a corresponding increase in self-regulation itself. All stock exchanges are required to be recognized; self-regulatory organizations (SROs), which are technically different from stock exchanges under securities legislation, may or may not be recognized. Once a body is recognized by a securities regulator (and has therefore gone through the appropriate application and approval process), it is subject to regulatory oversight. This means that securities regulators oversee the SRO by reviewing and approving by-laws and hearing appeals of decisions of the SRO, for example. Recognized SROs include the Mutual Fund Dealers' Association (MFDA), Market Regulation Services Inc. (RS Inc.) and the Investment Dealers' Association of Canada (IDA), all of which occupy a central place in the regulation of Canadian capital markets. The proposed consolidation of RS Inc. and the IDA serves as reminder of the importance of SROs in the overall regulatory framework.

[4] For example, in setting forth its recommendations regarding take-over bids, the Kimber Committee stated that the primary objective of the legislation should be the protection of the bona fide interests of the offeree shareholders. However, such legislation "should not unduly impede potential bidders or put them in a commercially disadvantageous position vis à vis the bidder…." (Kimber Report, 1965).

Self-regulation is efficient in that regulatory functions are delegated from a principal regulator, such as a securities commission, to another body that has direct contact with and control over individual members of the particular SRO. Monitoring is achieved more easily and enforcement can be more timely and effective as a result. The current system of recognition and oversight is a useful structure with which to delegate powers to SROs and thereby allow an effective division of labour among regulatory bodies.

ii. Firm Size and Type

The Puri study completed for the Wise Persons' Committee (2003) found that micro-cap issuers represent 52% of all issuers listed on either the Toronto Stock Exchange (TSX) or the TSX Venture Exchange. Small-cap issuers represent 30% of all issuers listed on either the TSX or the TSX Venture Exchange (Puri, 2003). These numbers suggest that less than 20% of issuers are neither micro- nor small-cap companies.[5] This is instructive from a regulatory perspective, because securities regulators do not simply regulate for the largest companies, they regulate all public issuers regardless of size.

Some have advocated a two-tier structure of regulation that distinguishes between different sizes of companies. Daniels and MacIntosh argue that the "first" market consists of large public corporations with significant public floats and large institutional shareholders, whereas the "second" market consists of smaller public companies with small public floats and no institutional shareholdings (Daniels and MacIntosh, 1991; MacIntosh, 1993). Certain aspects of Canadian securities regulation already draw such distinctions. For example, the disclosure rule relating to corporate governance practices (National Instrument 51-102) exempts venture issues from filing Annual Information Forms (AIF).[6] Another distinction existed until recently in rules relating to short form offerings.[7]

Another way of looking at the issue from a regulatory standpoint is whether the issuer is seasoned or not. Unseasoned issuers have no established disclosure records and may not have raised any capital in the public market. By contrast, seasoned issuers are known in the market, have been subject to audits, and tend to meet any number of investment criteria that investors may have, including strong stock

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[5] The Puri study defined a micro-cap issuer as having a market cap of less than $5 million and a small-cap issuer as having a market cap of $5-7 million.
[6] National Instrument 51-102 "Continuous Disclosure Obligations" (2004), 27 OSCB 3555.
[7] Issuers would qualify to use this system based on whether they met the "Basic Qualification Criteria" or the "Alternative Qualification Criteria for Substantial Issuers". The Basic Qualification requirements included a condition that the aggregate market value of the issuer's equity securities listed and posted for trading on an exchange in Canada is $75 million or more. The Alternative Qualification Criteria threshold was $300 million. These requirements were removed in December 2005. See National Instrument 44-101 "Short Form Prospectus Distributions" (2005), 28 OSCB 83.

performance; a minimum current or debt to equity ratio; a reasonable debt to asset ratio; a minimum level of dividends; a minimum asset level; P/E ratio; and trading volume. As a result, they are considered to be less risky than unseasoned issuers because they are more mature, more closely tracked by analysts and the financial press, and have greater information flow and access to capital markets.

In a regulatory system that attempts to reduce information asymmetries, perhaps seasoned issuers should be treated differently than unseasoned issuers. This is a point that appears to be accepted by Canadian securities regulators in certain contexts, such as recent corporate governance regulation that draws a distinction between venture and non-venture issuers. It is useful for securities regulators to draw distinctions between sizes and types of issuers, as discussed further below.

iii. Investor Type and Activity

Generally speaking, the investor class in Canada is bifurcated into retail and institutional investor classes (Deaves, 2006). Institutional shareholders have come to own large stakes in our public companies. For example, in 1950, institutional investors in the U.S. controlled assets worth $107 billion. This grew to $2 trillion by 1980 and $6 trillion by 1990 (MacIntosh, 1993). Today, the Ontario Teachers Pension Plan Board (Teachers) has $81.7 billion in assets under its administration (Teachers, 2005) while the Ontario Municipal Employees Retirement Board (OMERS) has approximately $36.2 billion in net investment assets.[8] The British Columbia Investment Management Corporation manages $67 billion worth of assets. The Caisse de dépot et placement du Québec has net assets that totalled a record $102.4 billion as at December 31, 2004, and its total assets under management amounted to $174.7 billion.

The sheer size of these holdings suggests that institutional investors are some of the most significant players in the Canadian securities landscape. For example, Teachers has been able to influence corporate decision making, and particularly voting, by revealing its positions on issues to be voted on at the shareholder meetings of companies in which it holds shares. Teachers have also proven to be a vigilant corporate governance monitor on which retail shareholders can free-ride. It has done this in part under the auspices of the Canadian Coalition for Good Governance, an umbrella group of institutional investors that has a collective interest in promoting principles of good governance.

[8] Of this, 81.6% is invested in public markets, 4.1% in private equity, 3.5% in infrastructure, and 10.9% in real estate. See OMERS, 2005

Retail investors generally invest through dealers whether in the mutual fund sector or otherwise. A high number of investors invest in mutual funds. During the 1990s, assets under management grew from $25 billion in December 1990 to $426 billion by December 2001, an increase of 1,700 percent. These assets were managed in approximately 1,800 different mutual funds and held in over 50 million unit-holder accounts (Department of Finance, 2002). By the end of 2004, mutual fund investments totalled over $522 billion in more than 1,900 different funds, accounting for 27% of the Canadian wealth market. In the United States, mutual fund investments account for 29% of the wealth market (Investor Economics, 2005).[9]

Hedge funds have also grown significantly in recent years as they attract a wide range of retail investors in addition to their traditional base of sophisticated investors. Hedge fund assets totalled $26.6 billion, consisting of $10.9 billion in pension plan assets, $14.1 billion in domestic hedge fund products (including principal-protected structured products) and $1.6 billion in offshore funds run by Canadian managers.[10] Unlike mutual funds that are regulated under securities regulation, hedge funds qualify for exemptions from securities regulation.

While retail investors generally invest through a dealer, the past decade has also witnessed the growth of the "day trader": investors trading on their own account over the Internet. A study by the North American Securities Administrators Association (NASAA) reported that in 1999, in the U.S., there were 62 firms offering day trading services, with a total of 287 branch offices.[11] There was only one firm in Canada at that time, Swift Trade Securities (NASAA, 1999). The NASAA report cited an organization that reported that there were about 5,000 individuals in the U.S. who were trading full-time through day trading brokerages, making a total of 150,000 to 200,000 trades per day (this equalled nearly 15% of the daily NASDAQ trading volume).[12] According to Swift Trade Securities' website in 2001, regulatory changes in Canada decreased the spread between the bid- and ask-prices on individual stocks, which led to a decrease in the number of day traders in this country.[13]

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[9] Investor Economics defines "wealth market" as "all investable financial assets held by Canadians; Includes Deposits – including Fixed Term Savings, GIC's GIA's Funds – Long and Short Term funds; Mutual funds; segregated funds and Group Segregated Funds; Fixed Income Instruments – Canada Savings and Government Bonds; Mortgage Backed securities; Equity – Common and Preferred Shares; Income Trusts and hedged funds – DBPP's are not included in these figures".

[10] This was a study done by Investor Economics (June 2004). See summary of report at Hedgeweek, 2006.

[11] In terms of brokerages, day trading firms differ from traditional brokerage firms in that they provide the means for customers to trade their own accounts and promote and facilitate a particular type of trading.

[12] This organization is called the "Electronic Traders Association."

[13] See www.swifttrade.com/index.html.

There has also been significant growth in private equity investing in Canada. In 2002, Canada's venture capital and private equity funds managed approximately $22.5 billion in capital.[14] Further, the private equity sector is growing as a result of funds emanating from three main sources. First, pension funds have been progressively investing in private equity projects[15] (Erman, 2005). Second, a growing class of private investors (many of whom were successful during the technology boom of the late 1990s) is seeking to invest in private rather than public markets. The third source of private equity results from an overcrowded U.S. market resulting in U.S. investors' interest in Canadian companies.

Viewing these changes in classes of investors, a number of issues arise from a securities regulatory standpoint. Has the growth in private equity been spurred by an excessive regulatory regime? Does the regulatory burden discourage firms seeking to access capital in Canada's public markets? In this vein, it would be useful to ascertain the number of issuers that have gone private in the past decade and, more generally, to ascertain the overall balance between private and public investing in this country. Importantly, one must also note the dominant presence of institutional investors, including their relative sophistication.

iv. Ownership Structures

The absence of a preponderance of widely-held companies is characteristic of Canadian capital markets, which are dominated instead by concentrated ownership structures (Daniels and Iacobucci, 2000). Indeed, Morck et al. have demonstrated that through the first part of the 20th century, large pyramidal corporate groups controlled by wealthy families and individuals were predominant in Canada. By the middle of the century, diffuse ownership expanded in Canadian companies but from the 1970s onwards, the pyramidal structure once again replaced the dominance of the widely-held firm (Morck et al., 2004). The corporate landscape is thus heavily populated with non-institutional, controlling shareholders (Daniels and MacIntosh, 1991; MacIntosh, 1993).

A further defining feature of the Canadian corporate landscape is the relative popularity of the dual-class share structure. With this mechanism, which is designed to avoid dilution of control in a public company, the corporation creates different classes of shares with different voting rights. These dual-class share structures alter the normal 1:1 relationship between cash flow rights and voting rights (Gry, 2005). Firms with dual-class share structures tend to have control concentrated among a small number of shareholders.

[14] Macdonald and Associates, Ltd. (see www.canadavc.com) and Canadian Venture Capital Association (CVCA) (see www.cvca.ca). See also Cumming, 2003.
[15] Teachers' has $7 billion in private equity assets.

The concern is that agency problems can arise because non-management or non-controlling shareholders cannot easily exercise control or implement changes when company performance suggests change is necessary. Indeed, firms with dual-class share structures appear to have inferior governance practices overall (Anand et al, 2006).

Thus, in devising regulation, regulators must consider that shareholder approvals, particularly those requiring some "special majority", are not always an appropriate check on management. Most often, one finds shareholder approval provisions in corporate law statutes but they do exist in the securities regulatory sphere also – such as in the take-over or merger context. The point is that in capital markets with a preponderance of controlling shareholders and dual class share structures, shareholder approval is not synonymous with investor protection.

v. Type of Securities

A distinctive feature of Canadian capital markets is the growth of innovative securities, such as hedge fund products discussed above and the income trust. While the first Canadian tax ruling enabling the income trust structure was handed down in 1985, it was not until the tech boom fizzled in 2000 that the income trust initial public offering (IPO) market resurged. It is reported that by 2002, income trusts accounted for 79% of all IPO revenues in Canada and by 2005, the income trust sector was worth $160 billion (Wikipedia, 2005). By comparison, while a form of business trust structure existed in the U.S. in the early 1980s, few remain today.[16]

Of further significance is that debt markets are relatively deep in Canada compared to equity markets. In 2004, equity issuances totalled about $29 million, while debt totalled $59 million. Government debt issuances totalled $105 million.[17] Information asymmetries are generally less in debt than in equity markets. Debt can generate information about the quality of management and the efficacy of business strategy (Jensen, 1989; Harris and Raviv, 1990). One of the primary vehicles through which information passes in the debt context is rating agencies which play an important role in providing information to investors according to standardized quality categories (Kuhner, 2001). Arguably, the presence of rating

[16] This may be because of favourable tax treatment in Canada and also because investors who would otherwise invest in the trust structure began to favour high-yield bonds or debentures. It is true that U.S. investment bankers have attempted to import the Canadian model in a structure called income depository shares since 2003. More and more companies have opted to go public in the raging Canadian trust market.
[17] This total was made up as follows: Federal Crown Corporation ($90,896.92m); Federal Government ($535,291.33m); Municipal Government ($35,388.05m); Provincial Crown Corporation ($41,626.55m); and Provincial Government ($192,851.31) (IDA, 2005b).

agencies serves to narrow the information gap between issuers and investors. With a rating agency, investors may feel less need to perform their own detailed analysis of the fairness of the offering price and other information provided by an issuer.[18]

It is crucial that regulation be sensitive to capital market conditions, including types of securities commonly issued and the means by which investors tend to hold shares (mutual funds, etc.). If information asymmetries are less in the debt context, and debt issuances are common for sophisticated investors or in certain sectors, perhaps the need for disclosure in these contexts is less. These are issues that are central to regulatory decision-making.

vi. Prevalence of Technology

The Internet plays an increasing role in capital markets, including in the purchase and sale of securities and disclosure of information. Investors are able to invest in an issuer directly by utilizing the Internet site of a securities dealer registered to trade securities in their jurisdiction. Furthermore, an issuer is able to offer to sell its own securities over the Internet in certain circumstances (such as obtaining a receipt for a prospectus and being registered to trade in its own securities). Issuers can transmit certain financial disclosures over the Internet to their investors upon request by the investor. Without question, technology − computers, financial software, webcasting and electronic mail − plays an integral role in heightening the informational efficiencies of capital markets.

Canadian securities regulators have kept pace, generally speaking, with developments in information technology. For example, the System for Electronic Document Analysis and Retrieval (SEDAR) is now a deeply ingrained facet of the disclosure regime and the System for Electronic Data on Insiders (SEDI) is a crucial means of disclosing information relating to insider trades. In addition, shareholders can request electronic delivery of financial statements. However, consideration needs to be given as to whether an "access-equals-delivery" model should be implemented on a broader basis, as is now the case in the United States.[19]

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[18] Apart from the rating agency, debt can generate information in other ways. First, the inability of a firm to make its contractual payments to debt holders provides information about the firm's financial status. Second, if a firm is in default and seeks to avoid liquidation, investors can receive information about negotiations with creditors from the press or through disclosures made in formal bankruptcy proceedings.

[19] Securities and Exchange Commission, "Securities Offering Reform; Correction (technical amendments)" (2006) Release Nos. 33-8591; 34-52056; IC-26993; FR-75.

In particular, a key legal question is whether law should place the onus (or more of an onus) on shareholders to access disclosure once it is made publicly available on the Internet or continue to rely on the traditional paper-based model and all that it entails (Anand, 2001). There are significant benefits to be gained from adopting an access-equals-delivery model (Sarra, 2006). It is more efficient, surely, in terms of time. Shareholders would be able to access disclosure posted to SEDAR shortly after they are posted, whereas they may have to wait days to receive the same disclosure in the mail. Further, it is not clear that shareholders, especially retail shareholders that often do not behave as would the archetypal *homo economicus* (see Deaves, 2006), would even read disclosure documents if they are sent to them. With an access-equals-delivery model, the time required to prepare hard copy reports and send them out is saved, as is paper and other materials consumed to do so.

The benefits of an access-equals-delivery model (here cursorily reviewed) are extensive. The question is whether such a model undermines investor protection concerns. It appears that investors would not be less protected under such a model, especially with the expanding use of the Internet. Given that investors can currently access SEDAR - a secure website containing issuers' public disclosures - it stands to reason that the "next step" in the evolution of our disclosure based system is to adopt a more extensive access-equals-delivery model.

vii. Recommendations

<u>Recommendation #1:</u> Securities regulation in Canada should take into account the distinctive aspects of Canada's capital markets, such as the preponderance of small- and mid-cap issuers, ownership structures typical in Canadian capital markets, the preponderance of institutional and controlling shareholders and the types of securities issued.

<u>Recommendation #2:</u> Consideration should be given to whether an access-equals-delivery model should now be more broadly implemented in Canada. With the existence of SEDAR and SEDI, it stands to reason that the "next step" in the evolution of our disclosure based system is to adopt a more extensive access-equals-delivery model.

5. Weighing Stakeholder Interests

It is impossible to assess whether balance has been achieved in securities regulation without understanding the terms used to assess balance and the methodologies employed to undertake this task. This section will examine various alternatives, all somewhat imperfect, that can be used to assess balance. These methodologies overlap and are not mutually exclusive.

i. Objectives of Securities Regulation

Securities regulation aims to accomplish a number of objectives, often cited as consisting of investor protection and market efficiency. However, the legislation is more explicit, stating that the purposes of the legislation are, "to provide protection to investors from unfair, improper or fraudulent practices; and … to foster fair and efficient capital markets and confidence in capital markets."[20] While there may be tension among these objectives, it is not necessarily the case that they conflict. Much depends on the context in which they are used. The IDA has recognized the tension between these goals, stating, "Under supervision of securities commissions, it [the IDA] aims at a balanced approach to regulation, taking into account the often complementary, but occasionally conflicting, goals of investor protection, efficiency and competitiveness" (IDA, 2006).

The notion that these objectives conflict has a firm basis in law and economics academic literature. A fundamental tenet of this literature is that regulation, including laws aimed at investor protection, is unnecessary: private parties will enter into their own contracts and seek to protect their own interests through these contracts (Easterbrook and Fischel, 1984). Courts play a significant role in enforcing such contracts (Coase, 1960), but regulatory law is generally unnecessary as a means to bind sophisticated parties (with the exception of rules relating to fraud). Investors will contract with the corporations in which they invest and will exit if they recognize a risk of expropriation. This view treats investors as rational actors who do not need their hands held by paternalistic regulation. It also minimizes the importance of law as a facet of achieving efficient capital markets.

However, empirical literature has suggested that there is a baseline level of importance of investor protection laws. It appears that these laws are not simply good for the individual investor, but also for capital markets generally. Studying 49 common law and civil law countries, La Porta, Lopez-di-Silanes, Shleifer and Vishny (LLSV) have demonstrated a statistically significant relationship between liquid

[20] *Supra* note 1, s. 1.1

securities markets and certain minority protections afforded by law (LLSV, 1997, 1998). They have concluded that capital markets left unregulated do not lead to more secure markets. Rather, financial markets require laws, and particularly laws that protect investors, to prosper. Subsequent research has similarly suggested that a stringent legal environment means fewer private benefits of control (e.g. Nenova, 2003; *cf* Coffee, 2001).

One of the weaknesses of the LLSV thesis is that while law may matter as a general proposition, it does not speak to the potential inefficiencies contained in a voluminous body of law. There may be a threshold above which additional investor protection laws do nothing, or do little to enhance market efficiency (a diminishing returns argument). In advanced economies such as Canada and the United States, where investor protection laws are generally very strong, it stands to reason that an ever-increasing volume of investor protection law will not necessarily result in a corresponding efficiency gain. In this vein, Roe (2003) acknowledges that the LLSV model may explain the economies of less-developed countries but not those of developed economies such as the United States. Furthermore, we should note that the variables examined by LLSV relate more to what is considered to be corporate law rather than securities regulation, as discussed below. Nevertheless the LLSV studies suggest that investor protection and market efficiency support each other at least up to a base level of regulation, which reduces agency costs that can exist in the absence of regulation.

ii. Concepts of Efficiency

Perhaps the most significant issue in weighing issuers' interests with investors' interests is defining these interests and, specifically, understanding what is meant by "market efficiency" and "investor protection" in any given instance. This section canvasses various conceptions of efficiency and examines how they relate to the concept of investor protection. It may be that regulators attempt to enhance informational and allocational efficiency while minimizing transaction costs. However, in regulatory initiatives to date, it is often unclear which conception of efficiency regulators are employing. Furthermore, the statement of objectives in the *Securities Act* (Ontario) asks regulators to balance a number of objectives, including market confidence investor protection and fair and efficient capital markets, as discussed above. This list of objectives has the potential to be convoluted. This section seeks to distil the complex notion of efficiency

a) Informational Efficiency

Informational efficiency, otherwise known as the "efficient markets hypothesis" (EMH), relies on the concept of whether the observed market price of a security reflects all information relevant to pricing the security. As Fama (1995) explains:

> In an efficient market, competition among the many intelligent participants leads to a situation where, at any point in time, actual prices of individual securities already reflect the effects of information based both on events that have already occurred and on events which, as of now, the market expects to take place in the future. In other words, in an efficient market, at any point in time the actual price of a security will be a good estimate of its intrinsic value.

An efficient market is one that is efficient in processing information. Disclosure of information is considered to be the legal tool by which efficient markets can be achieved. There are differing types of efficiency: weak-form (historical price and volume information is reflected in the current price of the security); semi-strong form (all public information is reflected in the current price of the security); and, strong-form (all public and private information is reflected in the current price of the security). Commentators have generally agreed that capital markets in this country, like the United States, are semi-strong form efficient (Baesel and Stein, 1979; Fowler and Rorke, 1988; Suret and Cormier, 1990). That is, the price of any given publicly traded security reflects all publicly disclosed information.

While securities regulation strives to maximize informational efficiency, it must be recognized that our capital markets will likely never be strong-form efficient: certain information within a firm is permitted to be kept private in order for the firm to conduct its business effectively. However, insider trading laws exist to prevent those who have access to undisclosed material information from using it for their own gain. The consensus in common law countries is that this behaviour by insiders would be unfair and undermine market confidence.[21] Thus, efficiency *and* investor protection elements underpin disclosure laws.

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[21] Consider the Kimber Committee's statement that, "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 in question this concept lessens the confidence of the investing public in the market place and is, therefore, a matter of public concern" (Kimber Report, 1965).

In markets that do not prohibit insider trading, investors would likely require a higher expected rate of return to compensate them for this unfairness. This "premium" creates a less efficient market since, other things being equal, it leads to a higher cost of capital to issuers. Therefore, disclosure requirements coupled with a prohibition on insider trading (and the enforcement of both) is perhaps an optimal realistic solution, leading to the most efficient possible markets.

b) Allocational Efficiency

Allocational efficiency refers to the effectiveness with which a market channels capital to its highest, most productive uses. Efficiency in this sense ensures that the market provides the lowest cost of capital to issuers. Generally speaking, the more regulation, the less perfect the mechanism for allocating capital becomes, since regulation threatens the ability of the market to allocate capital at low cost and may add distortions to this mechanism. The concept of allocational efficiency forces us to remember that "capital will flow to companies that operate most efficiently, and reducing obstacles to capital flows will promote economic growth around the world and improved trade opportunities…." (Wallison and Smith, 2005).

Regulation can cause issuers to prefer certain means of raising capital based on factors other than price or cost. In particular, issuers may have regard to how onerous the regulation is and what the ongoing regulatory implications are of raising capital by a particular method. They may make decisions about whether and how to raise capital based on regulation or regulatory impacts, rather than where the cheapest form of capital can be obtained. This adds inefficiency to the market and, specifically, distorts its allocational efficiency. Thus, a key question to be considered in policy making is whether the proposed regulatory change imposes costs or other disincentives that affect issuers' behaviour regarding their capital-raising choices.

However, allocational efficiency does accord with investor interests in one sense. If a market is allocationally efficient, companies with the highest expected risk-adjusted rates of return will be allocated capital. Investors will receive the highest "market wide" returns when this allocation mechanism is operating properly. Investors likely care less about the governance of any one firm than about the return they will receive on their investment. Indeed, their ability to diversify is a major advantage: the more competition there is for their scarce capital, the lower the costs of their investment and the greater their expected returns. A properly functioning market also leads to the lowest cost of capital to issuers and contributes to the country's economic growth (Wallison and Smith, 2005).

However, in the allocational efficiency context, one may also see tension between the interests of issuers on the one hand, and investors on the other. The more regulation, the more potentially inefficient the mechanism for allocating capital will become. Although investors generally may favour a developed regulatory regime, increased regulation provides greater opportunity for this regulation to distort the allocation mechanism, with negative implications for issuers and economic growth generally.

c) Pareto Optimality/Kaldor Hicks Efficiency

Related but conceptually distinct from allocational efficiency is the notion of efficiency from a cost perspective. This idea derives from the Pareto Optimality (PO) concept that asks whether a proposed legal change would make citizens better off without making any one person worse off. Kaldor Hicks (KH) efficiency is a variation on this concept, asking whether this particular legal change would generate sufficient gains such that those who benefit under the initiative could, hypothetically, compensate those who do not, and still come out ahead (Trebilcock, 1993). Thus both PO and KH efficiency contemplate reallocation of resources, but in different senses from the notion of allocational efficiency sketched above. While PO and KH address the efficiency of a particular policy initiative, allocational efficiency refers to the efficacy by which markets themselves channel capital to their most productive uses.

But how do we assess the concepts of "better off" and "worse off" in the regulatory sphere? One means is by analyzing the costs - including transaction costs, but also costs more broadly, as discussed below - associated with the particular legal initiative and weighing them against the corresponding benefits. This is known as cost-benefit analysis (CBA). Here, we should note that CBA is built into the regulation, unlike other concepts of efficiency that seem to be implicit but are not discussed explicitly in the legislation. For example, the *Securities Act* (Ontario) provides that the Commission shall publish "a description of the anticipated costs and benefits of the proposed rule."[22] The Act also states that the OSC shall have regard to the notion that "business and regulatory costs and other restrictions on the business and investment activities of market participants should be proportionate to the significance of the regulatory objectives sought to be realized."[23]

It is true that securities regulatory initiatives in Canada contain various forms of CBA. As discussed below, it is often uncertain what benefits and costs regulators consider when they publish CBA, the bases on which they reached their conclusions, and whether alternative methodologies or criteria could have

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[22] *Supra* note 1, s. 143.2(2)(7).
[23] *Supra* note 1, s. 2.1(6).

been used (thereby rendering a differing conclusion). Further, it is not always possible to predict and quantify the costs and benefits of proposed regulation. This difficulty pervades CBA generally and highlights the need for regulators to review the regulatory initiative implemented on the basis of a particular CBA after a certain period of time. The importance of sunsetting new regulatory initiatives is discussed below.

d) Need to Differentiate

The way in which securities regulators interpret and define "efficiency" in any given instance makes a difference. To begin, "there are equilibrium allocations that result from a system of perfectly competitive markets that are informationally efficient, but not allocationally efficient, and vice versa" (Huang, 2005). For example, Dow and Gorton (1997) argue that informational efficiency does not have a specific role to play in allocating capital, primarily because of managers' discretion in the level of a firm's investment. They argue that informational efficiency is neither a sufficient nor a necessary condition for allocational efficiency. In other words, the differences among types of efficiency are significant.

There is, at present, no statutory basis for securities regulators to take into account one type of efficiency over another. One may presume that securities regulators, as a matter of practice, attempt to enhance informational and allocational efficiency while protecting investors. However, from current rule-making initiatives, it is not clear that this is indeed the case. While the *Securities Act* (Ontario) states that market efficiency is an objective of the regulation, it (wisely) does not specify which type of efficiency regulators should seek to achieve. However, the result is ambiguity in terms of how investor protection objectives should be balanced with efficiency concerns. As a first step in balancing the concerns of issuers and investors, therefore, it is important that regulators in their lawmaking explicitly identify or describe the type of efficiency that they are seeking to achieve and the ways in which the particular regulatory initiative seeks to attain this objective.

e) Recommendation

<u>Recommendation #3:</u> In light of the different ways in which "efficiency" can be defined, it is necessary for securities regulators to identify the concept(s) of efficiency that are driving a particular legislative initiative and the ways in which the particular type of efficiency is being achieved under the proposed initiative. Doing so will aid in understanding whether the proposed regulation achieves an appropriate balance between efficiency and investor protection.

iii. Methodologies

a) Requests for Comments

One of the main ways in which securities regulators ascertain the need for regulation, including particular nuances that the regulation should contain, is to request comments prior to implementing a rule or policy. The request for comments is in fact a legislated aspect of the rule-making procedure in the *Securities Act* (Ontario).[24] While the comments are informative, the sample group is self-selected and therefore not representative of the entire affected population. Furthermore, the data is qualitative and thus limited in terms of the types of conclusions that they can yield. Thus, requests for comments should not be all that is used to justify proposed legislation.

b) Empirical Studies

Conspicuously absent from securities regulatory initiatives in Canada are rigorous empirical studies that test the efficacy of the regulation and aid in justifying the implementation of additional regulation. Admittedly, some studies have been undertaken on a limited basis by commissions or individuals at the request of commissions (e.g. Puri and Sen, 2003). Without the benefit of rigorous empirical evidence, however, the rationale for proposed regulation is more suspect as one can legitimately question whether the regulation will be effective in achieving the intended results.

In many cases, it is possible to analyze the effects of regulatory initiatives through statistical studies, including event studies, regression analyses that test the relationship among relevant variables, surveys, etc. While reviewing the history of the private agreement exemption in the take-over bid area, Daniels and MacIntosh (1991) express the importance of empirical studies:

> In a review of the evolution of the private agreement exemption, the absence of facts is astonishing. The fundamental purpose of securities regulation is the promotion of the interests of investors. Many of the theoretical arguments either in favour of or against the narrowing of the private agreement exemption have empirically testable implications for the welfare of investors. And yet, in the history that we have reviewed, no attempt has been made to seek out or

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[24] *Supra* note 1, s. 143.2(2).

commission any empirical investigations of the effect of narrowing the scope of the private agreement exemption on Canadian capital markets.

This statement is applicable to many of the central aspects of our regulatory regime. There are numerous methods by which one can test the comparative costs and effects of differing legal rules. Empirical analyses should be part of the regulatory process because as regulation becomes more complex, it also becomes more costly. Empirical tests do not "prove" the case for or against additional regulation, but they do assist in illuminating *ex ante* whether particular regulation would be beneficial and useful and who would benefit under the regulation if passed. Alternatively, such tests are useful to conduct *ex post* the implementation of a regulatory initiative in order to isolate the costs, benefits and risks of the initiative.

Admittedly, there will be occasions when it is not feasible to collect and assess empirical data and to perform the recommended cost-benefit analysis. There simply may not be any means of collecting data regarding certain market activity, or the matter is so urgent that there is insufficient time to collect the relevant data. In such cases, sunset clauses and *ex post* analyses should be considered. In other cases, even if it is possible to collect certain data, it may not be possible to conduct a statistically significant analysis with it. In cases where regulators do not complete statistical analyses prior to the introduction of new regulation, they should explain why it was not feasible to do so. This would mean that statistical analyses become the "rule" rather than the "exception".

Related to this, some may argue that empirically testing the effects of legislation is not possible *ex ante* the implementation of legislation. Depending on the particular issue to be tested and type of empirical analysis to be undertaken, this may be true. It may be more feasible to conduct such analysis *ex post* the implementation of the regulatory initiative. Thus, when regulation not empirically analyzed in advance is proposed, it should be sunsetted as a matter of course for a limited period (such as two to five years). Such a testing period would enable regulators to repeal implemented regulation that proves to be ineffective or too costly given the benefits achieved.

Some may question whether sunsetting all such legislation would result in regulatory overkill, especially in an era when issuers already face a heavy regulatory burden. The purpose of sunsetting is to make sure that proposed legislation will achieve the goals that it is designed to achieve. Thus, sunsetting is unlikely to result in overkill since presumably some of the initiatives that are proposed, and sunsetted, will not ultimately be maintained because they do not meet this objective. Furthermore, we should remember that there is already a review of securities legislation in Ontario every five years, the first of which has already occurred (FYR, 2003). It is possible in these reviews that legislation currently sunsetted will be analyzed and discussed. This process will assist in assessing the ultimate usefulness of the regulation.

<u>Recommendation #4:</u> As a general practice prior to the implementation of regulation, securities regulators should commission or undertake empirical studies in order to assess its costs, benefits and risks, and to determine whether the proposed regulation will accomplish the intended results.

<u>Recommendation #5:</u> Where it is not possible to conduct statistical analysis or cost benefit analysis regarding a particular legislative initiative, securities regulators should disclose precisely why it was not feasible to do so.

c) Cost-Benefit Analyses

As noted above, the *Securities Act* (Ontario) requires a description of the anticipated costs and benefits of proposed rules that the OSC publishes.[25] The OSC's use of CBA has been referred to as "boilerplate" (FYR, 2003). Boilerplate statements of the costs and benefits of proposed regulation lack meaning, and tell market participants very little about the regulatory decision making process that led to the proposed rule.

The United Kingdom Financial Services Authority (FSA) has a legislated process for undertaking CBA. Like the OSC, the FSA is required to undertake CBA but legislation sets forth guidelines which stipulate a multi-stage process to be followed in conducting the CBA. These stages include: first, a statement of the objective to be achieved, any external constraints to be taken into account, and the policy options to consider; second, a determination of the scope and depth of the analysis required; third, an assessment of the costs and benefits of the policy options and associated distributional effects; and, finally, an output containing the analysis of the costs and benefits considered.

In addition, the applicable FSA legislation identifies six impact categories that must be considered in stages two and three. These are: direct costs (costs to regulators of designing, monitoring and enforcing regulations); compliance costs (costs to firms, including internal and external expenditures); costs of production (including increases or decreases in quantity of goods produced); efficiency of competition

[25] Securities legislation of other Canadian jurisdictions does not contain a provision requiring CBA prior to the implementation of a rule.

(market competition maximizes social welfare where sellers compete on the basis of price and quality rather than trying to dupe consumers); quality of goods offered (increase in consumer surplus, resulting from regulations that improve the quality of the goods offered); and, variety of products offered (increase in consumer choices).

The U.S. Securities and Exchange Commission (SEC) also routinely incorporates CBA into its proposed and final rules. These CBAs are not usually based in statistical analyses and are qualitative in form (Schwartz, 2006). Staff economists may also undertake CBA, as was done in Ontario prior to the implementation of the rules relating to audit committee composition and financial statement certification. However, these CBAs are explicitly stated not to represent the views of the SEC (Schwartz, 2006). In short, the SEC's use of CBA is not formalized as it is in the FSA context. Indeed, the SEC's use of CBA has been referred to as inadequate, and some argue that it has lowered the quality of SEC rulemaking (Sherwin, 2005).[26]

In light of the discussion of efficiency above, it is useful to ascertain whether the benefits of proposed governance regulation outweigh its costs. Some scholars have advocated CBA of financial regulation by undertaking a quantitative analysis of costs and benefits (Zingales, 2004). However, while it is possible to be more specific in explaining the costs and benefits of a proposed rule, it is not the case that all costs and benefits are comprehensible or, for that matter, quantifiable. In the Canadian securities regulatory context, the difficulties in assessing costs and benefits were exemplified in the differing CBAs published with regards to proposed rules relating to audit committee composition and certification of financial information.[27] Prior to implementing these rules, the Canadian Securities Administrators (CSA) published a CBA prepared by the OSC. The CBA indicated that the benefits of the proposed legislation were in the range of $1 to $10 billion and that these benefits would outweigh its costs. The BCSC commissioned a separate study regarding the proposed rules. This CBA suggested that there were several flaws in the OSC's cost-benefit analysis and that the costs of the proposed legislation could well exceed its benefits.

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[26] The inadequacy of the SEC's use of CBA was highlighted in 2005 when a D.C. Circuit court struck down the SEC's mutual fund governance legislation for failing to determine "as best it can the economic implications of the proposed rule." See Chamber of Commerce of the United States of America v. SEC, 412 F. 3d 133, 143 (D.C. Cir. 2005). In fact, the mutual fund governance rule in question was based on a controversial CBA in which two of five SEC Commissioners dissented stating that the SEC had failed to consider costs imposed by the regulation. Congress subsequently passed legislation compelling the SEC to justify its position on the basis of CBA.

[27] See "Multilateral Instrument 52-110 and Companion Policy 52-110: Audit Committees" and "Multilateral Instrument 52-109 and Companion Policy 52-109: Certification of Disclosure in Companies' Annual and Interim Filings."

The debate about the costs and benefits of the proposed rules affects both investors and issuers at a profound level. A majority of securities regulators in Canada, as well as many investor advocate groups, viewed the proposed rules as essential to restoring investor confidence in the capital markets. Yet the costs of this legislation appear to be significant for corporations directly and for their shareholders indirectly. Neither of the commissioned CBAs was able definitively to reveal whether investors needed the proposed legislation or whether it would be effective in achieving the purpose for which it was intended. The conflicting data from two of the largest securities commissions in Canada (as but one example) highlight limitations of CBAs in the securities regulatory sphere. Furthermore, such conflicting analyses seem inevitable since results can vary depending on the methodology employed.

CBA is a useful tool to increase accountability but it should not be understood to be a complete justification for any given proposed rule. CBA is simply one means of analyzing proposed legislation, and without guidelines in place regarding the means by which it should be undertaken, CBA can be of limited use to market participants in assessing whether they favour the proposed rule in question. Thus, CBA is a necessary but not sufficient criterion on which regulators should base their decisions to implement additional legislation. Furthermore, CBA should be undertaken in a more systematic manner, akin to the process followed by the FSA. While the FSA guidelines may not be appropriate for Canada, securities regulators here should study criteria that should appropriately underpin CBA in the Canadian context. Alternatively, regulators and SROs could jointly engage in a coordinated effort to develop a common CBA methodology.

<u>Recommendation #6:</u> Regulation for which there is little or no empirical support should be sunsetted for a limited period of time, after which time regulators will conduct a revised and formal cost-benefit analysis or regulatory impact assessment. If appropriate, such an examination should include the use of statistical analyses to determine whether the regulation has had a positive impact on affected parties and whether the costs of such regulation are justified.

<u>Recommendation #7:</u> If CBA is to remain a central part of analyzing regulatory initiatives, the basis on which the CBA is undertaken must be formalized and made more explicit, as is the practice at the FSA. Specifically, publicly available guidance that provides formalized criteria on which regulators assess costs and benefits in any given case is necessary.

d) Regulatory Impact Assessment

One of the weaknesses of CBA as it is currently employed in Canada is the variable criteria on which it is based. In light of this problem, as well as the difficulty in quantification of costs and benefits, it is worthwhile searching for other means of assessing the impact of regulatory initiatives. Regulatory Impact Assessment (RIA) is a technique that includes CBA but also involves a broader risk-based analysis than CBA entails. CBA does not typically weight risks. That is, it does not consider risk from the standpoint of the relative likelihood of facing specific costs or attaining certain benefits for various relevant stakeholders. For this reason, it may be biased in favour of more regulation, since estimated costs of regulation are usually more certain than perceived benefits.

The following steps are often included in an RIA: identify and quantify the impact of the proposed legislation; isolate alternatives - which may be non-law based - to address the problem; undertake risk-based analysis; consult affected parties; and implement legislation only if necessary and if the impact assessment warrants such implementation. RIA also addresses benefits that may not be quantifiable - such as equity and fairness - that are important, especially from an investor protection standpoint.[28] RIA examines the impact that a change in law will likely have, as well as various alternatives for implementing the proposed change.[29] Who will be impacted by the change and what is the range of impact across sectors? What is the likelihood of the various impacts that the proposed change may have?

RIA is used in the U.K.[30] and was endorsed by the BCSC in developing the new securities act for that province. The *Securities Act* (Ontario) seems to contemplate some aspects of RIA when it provides that a notice of a proposed rule must contain "a discussion of all alternatives to the proposed rule that were considered by the Commission and the reasons for not proposing the adoption of the alternatives considered."[31] Perhaps formalized CBA could also include an examination of the range of stakeholders to be affected by the regulatory change. But the explicit strength of RIA is that it involves an examination of risks, including the weighting of these risks, associated with the proposed legislation. For example, if there is a high probability of a certain cost associated with the proposed regulatory initiative and a low probability of a certain benefit occurring, then the cost should be weighted much higher.

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[28] See for example RIA conducted in the U.K. with regards to "Reducing the administrative burdens of the tax system on small business."
[29] See Cabinet Office, 2006.
[30] See for example, U.K. , 2005 which contains a list of RIAs completed by U.K. government departments during these time periods. See also HM Treasury, 2003.
[31] *Supra* note 1, s. 143.2(2)(5).

<u>Recommendation #8:</u> Because of its focus on risk assessment in addition to costs and benefits, regulatory impact analyses should be adopted as a means of assessing regulatory initiatives.

6. Analysis of Four Areas of Regulation

Given the particular characteristics of Canadian capital markets, does securities regulation adequately balance the needs of investors with the interests of issuers? This section analyzes this question in the context of four aspects of the current regulatory regime: public offerings, the exempt market, corporate governance and take-over bids. The focus in each of the discussions is the policy basis or underlying rationale of the relevant regulation.

i. Public Offerings

The central role of integrated disclosure combined with a new liability regime for misrepresentations in continuous disclosure documents signifies the existence of a comprehensive system of secondary market regulation. "Integrated disclosure" refers to the combination of primary and secondary market disclosures that create a comprehensive information set about an issuer (see generally, Emerson, 1972). For example, the short-form offering rules rely on an issuer having a publicly available AIF. A key feature of integrated disclosure is the legal ability for disclosure documents to be incorporated by reference in other disclosure documents. The existence of integrated disclosure coupled with a secondary market liability regime is appropriate given that the preponderance of capital markets trading occurs in the secondary rather than the primary markets. However, this does not mean that offering rules do not require regulatory attention. On the contrary, rules that govern public and private distributions are crucial because they determine the ease (or lack thereof) with which issuers can raise capital.

This section examines whether offering rules should be further liberalized; the difficulties with monitoring and enforcement of inadequate or misleading disclosure; and, policy implications of such difficulties. To begin, it should be noted that offering rules in Canada function effectively, especially with the short-form prospectus rules in place and relatively recent innovations that harmonize these rules across Canada. However, with the recent liberalization of offering rules in the U.S., the question arises as to whether Canadian rules should similarly be made more liberal. This question becomes increasingly pressing as we consider the desire issuers have to reduce their transaction costs and seek out deep capital markets outside Canadian borders in which they can do so. The relevance of the Canadian legal regime is at the heart of the issue but, as discussed below, it is not a foregone conclusion that Canadian securities laws should blindly follow those in the U.S. and other countries.

a) Liberalizing the Regime?

In December 2005, the SEC implemented rules modifying the registration, communications and offering processes under the *Securities Act of 1933*.[32] The new rules created a new class of issuers called "well-known seasoned issuers" (WKSI), that is comprised of widely-followed issuers.[33] The rules seek to eliminate certain restrictions on offerings and to provide information to investors without delays that would impede issuers' timely access to capital. In particular, WKSIs are permitted to use "free-writing prospectuses" which are written communications that constitute an offer outside the statutory prospectus. These prospectuses may include e-mail messages, term sheets, news articles and more. Their content is unrestricted, but the terms of these documents may not conflict with the statutory prospectus. The rules establish a more liberal adaptation of the shelf registration process in that WKSIs can automatically register unspecified numbers of certain classes of securities without awaiting SEC review.[34]

One of the most significant aspects of the WKSI reforms is that they allow qualifying issuers to communicate freely with potential investors at any time, including the period just prior to the offering. On the other hand, non-qualifying companies must continue to observe a 30-day quiet period prior to the offering. Prior to the quiet period, these issuers are permitted to communicate freely though they are not permitted to publicize their public offering and should they engage in publicity outside the ordinary course of business, they must take reasonable steps not to repeat this publicity during the quiet period.

Canadian securities regulation in this area is more restrictive than the WKSI rule. Canadian issuers can use the short-form prospectus system, as well as Shelf and Post-Receipt Pricing Prospectus (PREP) procedures. The short-form offering procedures rely on a more restricted version of integrated disclosure

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[32] *Supra* note 19.
[33] To be classified as a WKSI, a registered issuer must already have been reporting and is timely in its Exchange Act filings for one year; and, either has a $700 million of world-wide public float OR has issued $1 billion in non-convertible securities other than [common shares], in registered offering for cash, not exchange, in the preceding three years. Issuers meeting the $1 billion threshold may register only non-convertible securities, other than common equity, unless they also have a $75 million public float.
[34] Issuers can also exclude more information from the base prospectus than from a regular shelf registration statement. Issuers can elect to pay fees on a pay as you go basis at the time of takedown of the shelf registration statement. Issuers can also add additional classes of securities and eligible majority-owned subsidiaries after effectiveness.

to enable companies to issue their securities quickly. In particular, any issuer that wishes to use these procedures must have filed an AIF. These procedures are intended to be open only to established issuers that have a substantial amount of disclosure already disseminated in the market (see generally Pritchard, 2006).

Two schools of thought present themselves regarding whether Canadian securities regulation should contain WKSI-type rule. First is the view that Canadian securities regulation is irrelevant because issuers gravitate to jurisdictions with deeper capital markets. Practically speaking, this means that large Canadian issuers will "fly south" regardless of the Canadian regulatory environment. Second is the idea that as long as issuers seek a Canadian presence, they will need to meet Canadian requirements.[35] Thus, Canadian securities regulation will have a baseline of relevance regardless of U.S. law.

These two positions are not opposed, though this may appear to be the case. No doubt large issuers cross-listed in the U.S. will be complying with a host of U.S. regulations, including the *Sarbanes-Oxley Act of 2002*[36] (SOX) and exchange listing standards. More onerous Canadian securities regulation usually increases transaction costs for all issuers and deters them from accessing Canadian capital markets. However, Canadian securities regulation should not, as a matter of course, blindly follow U.S. law. As argued above, "made in Canada" solutions are sometimes appropriate for Canadian capital markets due to their distinctive characteristics.

b) Front-End vs. Back-End Regulation

What is so distinct about Canadian markets that warrants not implementing WKSI or similar rules that further liberalize the offering process? In Canada, we see a "front-end/back-end" imbalance in regards to offering rules and disclosure requirements generally. This term refers to the balance between the regulation that issuers must follow (i.e. at the front end of the regulatory process) and the monitoring and enforcement of violations of that regulation (i.e. at the back end of the regulatory process). At the front end, securities regulation in many areas, including disclosure, is fairly comprehensive, whereas addressing these problems if they arise (i.e. at the back end in the monitoring and enforcement context) tends to be less comprehensive. Specifically, disclosure rules such as what should be the content of the

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[35] See Rubin, (2005) quoting Margo Paul, the OSC's director of corporate finance, states "If you've got a Canadian issuer that wishes to offer in Canada, and wishes to be listed on the Toronto Stock Exchange or the Venture Exchange, they also have to file a prospectus with us….They have to be a reporting issuer here. They have to comply with our continuous disclosure requirements. The fact an issuer would be subject to U.S. review does not derogate from the fact they're subject to Canadian review as well."
[36] *Sarbanes-Oxley Act of 2002*, Pub. L. No. 107-204, §408(a) (b) (c), 116 Stat. 745.

AIF or prospectus are well established, but the back-end enforcement of these obligations, including reviews of disclosure, occur only sporadically by issuer and certainly not on a national level.

A relatively new provision in Ontario's *Securities Act* allows the Commission to undertake checks of issuers' continuous disclosure. Section 20.1(1) states that "the Commission or any member, employee or agent of the Commission may conduct a review of the disclosures that have been made or that ought to have been made by a reporting issuer or mutual fund in Ontario…."[37] Notably, continuous disclosure reviews have occurred in various provincial regulatory authorities long before they had the express power to do so. The OSC, BCSC, Alberta Securities Commission (ASC) and Quebec's Autorité des Marchés Financiers (AMF) have for some time completed and published or provided summaries of such reviews and have formalized programs for monitoring continuous disclosure.[38] The OSC aims to review 25 percent of Ontario-based issuers annually (OSC, 2004a).[39] The ASC has completed at least fourteen such reviews (ASC, 2004).

While continuous disclosure reviews occur, at present, there is no requirement for securities regulators to undertake a review of issuers' disclosure. There is some ambiguity regarding whether securities commissions will or will not undertake a continuous disclosure review, how often they will do so, what the review consists of and, most importantly, what consequences will befall issuers that do not pass this type of review. In short, securities law *allows* continuous disclosure reviews but does not mandate them, and indeed allows securities commissions to undertake them on a wholly discretionary basis. By contrast, SOX requires the SEC to review disclosures of listed issuers on "a regular and systematic basis for the protection of investors…."[40]

The question that arises is whether investors are any better protected with the SOX-like provision. Investors would likely benefit from more certainty regarding the frequency and extent of continuous disclosure reviews. With the concept of integrated disclosure at the forefront of the offering process, and the majority of trading occurring in the secondary market, the veracity and completeness of an issuer's continuous disclosure is of unprecedented significance.[41] Issuers, not only investors, may benefit from

[37] Alberta is the only other province to have a legislative provision which provides for continuous disclosure reviews. See Securities Act, R.S.A. 2000, c. S.4, s. 60.2.
[38] See OSC Notice 51-706, (2001), 24 OSCB 6842 in which the OSC states that its goal is to review reporting issuers with an Ontario head office once every four years.
[39] See also *ibid.*
[40] *Supra* note 36.
[41] This is not the first time that concerns with the lack of a formalized process for monitoring continuous disclosure has been raised. See FYR, 2003 at 127.

more certainty in the law regarding the extent to which an issuer's continuous disclosure will be monitored and most importantly the consequences for falling short of the standards of review in a particular case.[42]

It is true that securities regulators have enforcement powers with which to address an issuer's lack of compliance with existing disclosure obligations. If an issuer's disclosure is inadequate, it may be placed on the defaulting issuer's list. The issuer may be the subject of a hearing before the securities commissions pursuant to the so-called public interest provision. In addition, securities regulators may require the issuer to amend its disclosure. However, the consequences for breach - and certainly breaches of differing magnitudes - are unclear. Without certainty in this area, the mechanism that may deter or prevent inadequate disclosure cannot function effectively.

c) Policy Implications

Once we understand the importance of the front-end/back-end balance, the question as to whether Canada should implement a WKSI rule can be more readily answered. We should not liberalize laws at the front end (e.g. by adding a WKSI type rule in Canada) without first maintaining a balance between front-end and back-end regulation. This is not to suggest that harmonizing securities rules between Canada and the U.S. is unimportant. On the contrary, there are strong arguments relating to efficiency and competitiveness to be made for aligning Canadian law with U.S. law[43], or at least ensuring that Canadian laws are not excessively stringent compared to their U.S. counterparts. However, as described in Part 4, there are differences between Canada and the U.S. in terms of capital market composition and the resulting interests at stake. Securities regulation that is in place in the U.S. may not be the most appropriate for Canada.

To correct the front-end/back-end imbalance, it is necessary to implement a broader system of monitoring issuers' continuous disclosure. In terms of the practicality of monitoring disclosure, this may necessitate devolving some responsibilities to SROs, particularly RS Inc., or stock exchanges. One of the strengths of the current system of self-regulation is that securities commissions share the burden of regulating

[42] Recently, a senior accountant at the OSC conducted a survey of companies' compliance with the audit committee rules. As reported in the Globe and Mail, he stated "We want to advise the market that we intend to conduct additional reviews in the future, that we're going to actively follow up on deficiencies identified in those reviews, and we'll pursue appropriate remedies where appropriate." See McFarland, 2006. The question that arises in response is: what are the appropriate remedies?
[43] See FYR, 2003.

capital markets with institutions that have more direct contact with market participants, in this case issuers.

The point can legitimately be made that the regulator's role in monitoring an issuer's continuous disclosure is lessened with the implementation of a secondary civil liability regime. That is, investors have a right of action directly against issuers and their representatives through private enforcement channels. Therefore, the role of public enforcement mechanisms is less. This is a valid point; one of the true advantages of the statutory civil liability regime is the division now between public and private enforcement. However, we should remember that the legislation is new just this year and it remains to be seen how effective the legislation will be as a private enforcement mechanism. Furthermore, the legislation contains both liability caps and extensive defences to liability. Thus, at this stage, it is not possible to conclude that the regulator's monitoring role in reviewing issuers' continuous disclosure is less important. Rather, this is an issue that needs to be examined once the legislation itself has been tested over time.

d) Recommendation

<u>Recommendation #9:</u> Prior to or concurrently with liberalizing rules relating to public offerings, securities regulators should implement a more formalized and national system of continuous disclosure review and make this system of review known to the public. Without certainty in this area, the deterrent mechanism that may serve to prevent inadequate disclosure cannot function effectively. This increased monitoring may include devolving responsibility for monitoring issuers' disclosure to SROs (particularly RS Inc.) or stock exchanges.

ii. Exempt Market

The exempt market is an area of securities regulation that has witnessed significant attention and subsequent legal reform over the past three and a half decades or so. There is a persistent lack of harmonization in the exemptions, an issue that the author has discussed elsewhere (Anand and Klein, 2003) and which is not within the mandate of the current report. Furthermore, the exempt market rules are constantly changing and seemingly "patchwork". Specifically, the list of exemptions and accompanying restricted period rules have been amended numerous times, sometimes yearly, since the inception of the closed system in 1979. Admittedly, this lack of coordination has decreased with recent efforts of the CSA to streamline and harmonize the exemptions across the country, specifically National

Instrument 45-106.[44] But as discussed below, this instrument exemplifies problems relating both to harmonization and the substantive rationales underlying certain exemptions. This section discusses three issues: whether and in what respects the closed system lacks relevance; the rationales underlying exemptions and the need for blanket orders.

a) Waning Relevance of the Closed System

Introduced in 1979, the closed system was designed to address concerns about backdoor underwritings and confusion over the requirement for a prospectus when there was a distribution to the "public". Under the closed system, all distributions are swept into the prospectus requirement (i.e. the system is "closed" around all distributions). Express exemptions from the prospectus requirement are then provided to allow distributions outside of this system. Any resale of a security acquired under an exemption is again made subject to the prospectus requirement (i.e. the system is "closed" in around the securities) unless the first purchaser of the securities resells them pursuant to another exemption.

With the closed system, recognition is given to the fact that once an issuer files a prospectus and becomes a reporting issuer, it becomes subject to the continuous disclosure requirements and develops a disclosure record and market following. The rationale is that without a prospectus, the securities distributed under an exemption would only be freed from the closed system provided the issuer is a reporting issuer and purchasers of securities under the exemption were considered to be bona fide purchasers and not facilitators of backdoor underwriting. To ensure purchasers are bona fide, securities regulation has historically mandated compliance with a hold period for the securities. The length of hold periods has decreased in recent years from 18, 12 or 6 months to 4 months in certain cases.

The question persists as to whether the closed system, or aspects of this system, lacks relevance in an era where secondary market disclosures about an issuer are comprehensive and issuers now bear liability for such disclosures. As we know, back-door underwriting is the process of completing what is essentially a public distribution of securities without a prospectus (Merger Report, 1971; FYR, 2002). Back-door underwriting seems to be less of a concern today than it would have been in the early years of the closed system, when a larger proportion of trading occurred in the primary market and when the monitoring of securities distributions was perhaps less comprehensive and less frequent.

[44] National Instrument 45-106 "Prospectus and Registration Exemptions" (2005), 28 OSCB (Supp-4).

Furthermore, investor protection concerns regarding resale appear less pronounced in today's capital markets. Seasoned issuers - such as an issuer that has been a reporting issuer for two years or more - typically have filed on a yearly basis quarterly and annual financial statements, quarterly MD&A as well as an AIF, a proxy circular and annual report. A significant amount - indeed the bulk - of information about these issuers already exists in its public continuous disclosure record. Furthermore, the more seasoned the issuer, the more analysts or selected sophisticated investors will be actually reviewing the issuer's disclosure. They will make recommendations or trade in the securities, which in turn increases the liquidity of the securities. For these types of reporting issuers, there is a body of disclosure in existence that should allay investor concerns about not having enough information about an issuer.

The existence of this public information means that first and second purchasers of securities always have the ability to examine information about the reporting issuer that is on the public record, including material change reports that this issuer will likely have filed when raising capital in the exempt market (though these documents often do not reveal information that is useful to investors). In addition, and perhaps more importantly, these investors will have the ability to sue the issuer for misrepresentations or omissions in such disclosures under the new legislation relating to secondary market disclosures. Finally, technological advances such as SEDAR permit much better access to - and faster dissemination of - information than in the early years of the closed system when the hold period concept was introduced in part as a mechanism to ensure the public was informed.

Admittedly, there may be some concern that even issuers that have an AIF on file do not have a substantial amount of information about them in the public markets, as in the case of a newer issuer. Thus, if the securities of these relatively unseasoned issuers were to become freely tradable without any hold periods and without a prospectus being filed for the new issue, investor protection concerns would more readily arise. The first purchasers of the securities would be able to sell the securities immediately without having to wait the four months and without a prospectus for the new issue on file. Because of this concern, it may be appropriate to specify that only securities of seasoned issuers, and specifically issuers that have filed quarterly MD&A over a certain period of time, are not subject to resale restrictions.

If the strength of a seasoned issuer's continuous disclosure record is not considered to be sufficient to allay concerns about backdoor underwriting, more significant change to the regulatory regime is possible. The FYR Committee (2003) suggested that first purchasers of exempt securities who purchase with a view to distributing the securities may bring them under the definition of "underwriter" and be subject to the related obligations. Furthermore, the Committee suggested amending the definition of "distribution" to capture trades that are backdoor underwriting without subjecting all trades to a restricted period.

In short, previous reasons to retain resale restrictions are less persuasive in an era where continuous disclosure records are comprehensive and issuers bear liability for such disclosure. It would make more sense in today's regulatory context for resale restrictions to depend on the issuer and the extent of its disclosure record rather than on the exemption utilized. If the issuer is seasoned and followed by analysts, the need for restricted periods is minimized. It would be useful to sunset such a significant amendment to existing regulation.

Much of this discussion assumes that investors read disclosure documents. Yet we know that often, this is not the case. The issue is not one relating simply to the difficulty in reading disclosure documents (thus plain language initiatives will not serve as a "quick fix"). The fact is that the notion of disclosure is so heavily ingrained in our securities regulatory system that we are unsure of how to deal with the fundamental issue that investors, certainly retail investors, do not as a matter of general practice, read disclosure documents. Furthermore, questions arise about the basis on which investors make decisions and how these basis vary depending on the type of issuer. (For instance, many technical analysts only analyze issuers with liquid public markets so they can follow the trading trends.) Until we understand how investment decisions are made, continuous disclosure regulation has more theoretical than practical relevance. Empirical studies are certainly warranted in this area (see Deaves, 2006). This is not to say that mandatory disclosure requirements do not serve any purpose, as discussed below.

<u>Recommendation #10:</u> Restricted periods should not apply to seasoned issuers that have complied with their continuous disclosure obligations and have filed AIFs and quarterly MD&A over a certain period of time (such as two years). If adopted, this change in the law should be sunsetted in order to determine whether investor protection concerns, particular the amount of disclosure available to first purchasers of securities regarding the restricted securities, arise.

<u>Recommendation #11:</u> Securities regulators should undertake an empirical review of the extent to which investors, both retail and institutional, review issuers' disclosure and the bases on which these investors make decisions. This review should include conducting a statistical survey of both retail and institutional investors and may also consist of determining the number of beneficial holders that have requested to receive disclosure documents.

b) Exemptions

The question persists as to whether individual exemptions appropriately balance issuers' and investors' interests. We will examine some of the main ones here, referring to National Instrument 45-106 which contains the following exemptions:

Accredited Investor Exemption: This exemption allows issuers to raise capital without a prospectus if they are selling to certain investors who meet the criteria set forth in the legislation. While the definition of accredited investor is not uniform across the country, the central idea underlying the exemption is that an investor must have a certain sophistication, generally as evidenced by: the type of entity they are (banks, insurance companies, governments at various levels, pension funds, registered charities etc.); and, the extent of their financial assets or net income. This exemption is broad enough to include many different types of investors within the definition of "accredited".

Many have criticized exemptions generally because it can be difficult for issuers to "fit within the four corners" of a given exemption (FYR, 2003). However, relative to other exemptions, the accredited investor (AI) exemption makes it easier for issuers to access private sources of capital. In particular, the AI exemption is based on the notion of sophistication: because of the investor's sophistication, he/she does not need the protection of the disclosure contained in the prospectus prior to investing. He/She is more aware of the risks associated with the transaction and issuer in which he/she chooses to invest.

The AI exemption is an ideal example of the flexibility that needs to be contained in securities legislation, especially in the exemption themselves. Sophistication conceived in this way is preferable to other rationales underlying the exemptions such as relationship to the issuer (discussed below) and the somewhat arbitrary $150,000 exemption now in place under National Instrument 45-106. While the $150,000 exemption is based on a sophistication of the investor concept, sophistication is defined narrowly by a relatively small monetary amount. Ultimately, this figure tells the issuer - and the regulator - very little about how sophisticated the purchaser is. It would do little to protect investors who may have $150,000 but who are not sophisticated in terms of their investing background.

Private Issuer Exemption: There are instances where non-public issuers will seek to raise capital from private investors. These non public or "private" issuers can distribute securities to certain individuals – directors, executives and their relatives, existing security holders and persons who are not members of the public – without a prospectus. By definition, a "private issuer" has no more than 50 shareholders (excluding employees etc.) and restrictions on transfer. For a period prior to the implementation of National Instrument 45-106, Ontario had in place the closely-held issuer exemption (CHIE) while most other provinces had retained the private issuer exemption. (Ontario's CHIE replaced the private issuer exemption.) For issuers, it was difficult to raise capital nationally with two similar but nevertheless different exemptions available specifically to these issuers while having different requirements in their articles.

The CHIE was cumbersome and difficult for issuers – let alone for investors – to understand. For example, under OSC Rule 45-501,[45] in order to utilize the exemption, an issuer had to be certain that it fell within the definition of "closely-held issuer" which meant that its outstanding securities were beneficially owned, directly or indirectly by no more than 35 investors at any one time excluding accredited investors and current or former directors, officers and employees. Keeping track of these 35 investors proved problematic. Further, there was a ceiling of $3 million that could be raised in aggregate under the exemption as well as a required information statement.

With the repeal of the CHIE, the regime is more streamlined and more efficient. Regulators should seek to avoid this type of exemption, remembering that ease in accessing capital markets in circumstances where prospectus disclosure is not considered necessary is the purpose of the exempt market itself. Exemptions that are difficult to understand are difficult to comply with and therefore hinder the efficient raising of capital. By contrast, the AI exemption is more straightforward, with investors needing to be certain that they fall within one of the enumerated classes of the definition.

Family, Friends and Business Associates Exemption: Securities are permitted to be sold to certain classes of people on an exempt basis, including: directors, executive officers and control persons of the issuer; founders of the issuer active in the business; certain family members, close personal friends and close business associates of the persons. This exemption is available in all jurisdictions except Ontario. If used in Saskatchewan, the purchaser must sign a risk acknowledgement form.

In terms of market efficiency, the fact that this exemption is available in all jurisdictions except Ontario is problematic. As a general matter, a useful practice going forward would be for exemptions that have been adopted in two-thirds of jurisdictions should be accepted in all others on the same terms. We would avoid the patchwork legislation that typifies the exempt market, moving towards greater efficiencies in the exempt market from a harmonization standpoint (Anand and Klein, 2003; 2005).

[45] OSC Rule 45-501 "Ontario Prospectus and Registration Exemptions" (2005), 28 OSCB (Supp 4).

Further, one may legitimately question the rationale underlying the family, friends and business associates exemption. The assumption is that the issuer (and its founding members) will not abuse these classes of individuals. But this is not necessarily a well-founded assumption. While an issuer may not intend to abuse the trust of its family and friends, its actions may have the effect of doing so. Indeed there are many instances in which family and friends stand to be taken advantage of in this type of situation. Basing exemptions on sophistication (as in the AI exemption) seems a more secure basis on which to allow issuers to distribute securities without a prospectus. Admittedly, another rationale underlying friends and family exemptions is that these people are not likely to base their investment decision on prospectus disclosure – either they have access to prospectus-level information by virtue of their position with the issuer, or (in the case of friends and family, for example) they may invest regardless of the disclosure in the prospectus. But the question still arises as to whether these individuals require more protection than currently provided.

We should note that the AI exemption does bring under its umbrella (i.e. in the definition of "accredited investor") certain relatives, including "spouse, parent, grandparent or child of an officer, director or promoter of the issuer." This provision is based on an indirect sophistication concept combined with a "common bonds" type analysis. Officers, directors and promoters are considered to be sophisticated and it appears to be assumed that they would advise their spouses, parents, children or grandparents. However, the analysis above regarding friends and family is pertinent here. Further, one may question why siblings of officers, directors or promoters are not included in the list of relatives.

Recommendation #12: Exemptions from the prospectus requirements should, where possible, be based on a sophistication of the investor rationale as opposed to the assumption that certain individuals with a relationship to the issuer will be protected because of that relationship. Exemptions should strive to be harmonized, easy to understand and easy to access.

Recommendation #13: In the interests of harmonization, exemptions that are acceptable in two-thirds of the provinces should be adopted as a matter of course in the remaining provinces.

c) Blanket Orders

Of course, it is possible that an issuer's transaction does not fit within any one particular exemption. The issuer can in this case apply to securities regulators for a blanket order for permission to complete the transaction that it is contemplating. Some commissions (e.g. British Columbia, Alberta and Nova Scotia) have the ability to issue blanket orders, although the OSC no longer does.[46] Regarding the Ontario regime, the Daniels' Committee stated that blanket rulings would no longer be necessary once the OSC had rule-making powers. The Committee reasoned that since blanket rulings and orders have a rule-like character, they should not be permitted (Daniels Report 1994; FYR, 2003).

We should remember that the Daniels Committee made its recommendations post-*Ainsley*[47] in an era where there was great sensitivity to the arbitrary use of the securities commissions' power. While this sensitivity is justified, it perhaps leads one to overlook the crucial point that blanket orders enhance efficiency – in terms of the time it takes an issuer to access its market – since an issuer can avoid the need to apply to the regulator for a blanket order. The potential downside of course is that in the blanket order context, law is made on a more impromptu basis than in the rule-making process. Furthermore, blanket orders adopted in one jurisdiction but not others decrease the level of harmonization across the country.

The trade-off here is between efficiency in allowing issuers to access capital markets and lawmaking by the securities regulator. However, the lawmaking issue should not be a roadblock. First, regulators already have a lawmaking function in their ability to grant exemption orders generally; it is inconsistent to sanction such lawmaking in one sphere but not in another, especially when there is a strong efficiency argument to be made in favour of blanket orders. Second, blanket orders have an inherent fairness quality: allowing any issuer to benefit from a blanket ruling previously granted to another issuer is more fair than only allowing one issuer to benefit from the original order. Third, unlike the relatively lengthy rule-making process, blanket orders can be issued quickly and can thereby respond to market needs. They can also be amended or repealed with ease compared to rules or legislative amendments.

It is true that blanket orders can detract from harmonization. But we should remember that jurisdictions outside Ontario have the ability to issue blanket orders or orders at present. Thus, the lack of harmonization brought on by blanket orders is certainly not a new issue for securities regulators and highlights the need to build towards a more efficient structure of securities regulation generally. Further, we should note that the CSA is more formalized as an organizational structure than it was even ten years ago when blanket orders were removed. It may be possible to address the lack of harmonization brought

[46] See FYR, 2003, "Blanket rulings and orders are rulings or orders of general application issued by a securities regulator that exempt classes of trades, securities, companies, transactions and other matters from regulatory requirements otherwise applicable."
[47] Ainsley Financial Corp. v Ontario Securities Commission (1994), 21 O.R. (3d) 104 (C.A.).

on by the (re)introduction of blanket orders at the CSA level at least by notification from one jurisdiction to another of orders granted as is currently the case.

<u>Recommendation #14:</u> Blanket orders should be reinstated as a means for issuers to gain permission to complete transactions that are not specifically contemplated in the regulation. Such orders should include permissions to raise capital in the exempt market.

iii. Corporate Governance

The breadth of corporate governance laws – laws that regulate the governance structure of the corporation over and above those contained in the corporate statute – has increased significantly in the past few years. This section examines the Canadian corporate governance regime compared to governance regimes in other countries. It argues in favour of more empirical studies in the area of corporate governance as well as taking into account market-based incentives in devising regulation.

a) Canadian Regime

Canadian securities regulators chose not to adopt SOX provisions carte blanche. Rather, they chose an approach tailored to Canadian capital markets by selectively adopting certain provisions of SOX and rejecting others. Other than mandatory rules relating to audit committee composition and financial statement certification, the Canadian corporate governance regime is not mandatory but is based on a best practices system regime coupled with a disclosure requirement. Canada's regime dates back to 1995 when the TSX issued a list of best practices that Canadian listed firms could voluntarily follow. Disclosure regarding the extent of a firm's compliance with the best practices was required in the firm's proxy circular or annual report (TSX, 2004). Provincial securities commissions now bear the responsibility for formulating and administering the corporate governance guidelines. They too have issued a voluntary code of best practices coupled with a mandatory disclosure requirement.[48] By contrast, the U.S. regime under SOX is largely mandatory.[49]

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[48] National Instrument 58-101 "Disclosure of Corporate Governance Practices" (2004), 27 OSCB 8854, which came into force on June 30, 2005, replaces the TSX Guidelines. Note that two aspects of the CSA's governance regime are indeed mandatory: the audit committee requirements under Multilateral Instrument 52-110: Audit Committees and the certification requirements under MI 52-109: Certification of Disclosure in Issuers' Annual and Interim Filings.

[49] See for example supra note 36 (codified in scattered sections of 15 U.S.C. and 18 U.S.C.) §§ 302 (requiring CEO and CFO signatures on reports), 304 (requiring CEO and CFO to reimburse the company for any bonus or profit on the sale of the company's securities that were made for a year before an accounting restatement due to that officer's

The U.K. regime under the 1998 Combined Code's best practice guidelines is similar to Canada's system (CCG, 1998). Compliance with these guidelines is voluntary, but companies listed on the London Stock Exchange are required to include in their annual report a statement indicating how the company applies the Combined Code's principles. Similarly, the Australian corporate governance regime revolves around the Australia Stock Exchange (ASX) guidance, which presents recommendations on how to achieve best practice in governance (ASX, 2003). The ASX guidance requires each listed company to provide a corporate governance statement containing disclosure of non-compliance in its annual report.

One of the advantages of a best practices regime is its flexibility. A requirement for an entirely independent board or audit committee may be onerous for the micro, small- or mid-cap issuer, which may only have a few directors on its board to begin with. Similarly, if the issuer has a small number of shareholders, some of whom are insiders, the benefits of having the chair and CEO roles separated may not be as apparent as they are in a widely-held firm. Further, micro, small- and mid-cap issuers will bear costs of a mandatory regime such as SOX disproportionately. A best practices structure is more flexible in this regard and is especially important in jurisdictions such as Canada and Australia given the preponderance of small- to mid-size public companies in these capital markets. It is instructive that the SEC Advisory Committee on Smaller Public Companies will likely recommend exempting micro-cap companies from SOX s.404, subject to certain conditions. The Committee stated that smaller public companies "have been disproportionately subject to the burdens" arising from s. 404 compliance.[50] In an economy with a large number of such firms, the burden of a mandatory regime would be amplified.

Yet even in Canada, the question persists as to whether we have too much corporate governance regulation: has the pendulum swung too far? This is a difficult question to evaluate because of the opposing views one encounters in the debate. Issuers have concerns that excessive compliance costs prevent them from devoting internal management time to developing and operating their business. Investors may favour corporate governance reforms because of the relationship they draw between enhanced firm performance and governance or because they see managers as rogues, or potential rogues, who need to be accountable for their conduct. Regardless of this opposition, we should note that there is

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misconduct), 401 (requiring financial statements to be prepared with or reconciled to GAAP), 403 (requiring officers and directors to report sales of stock), 404 (requiring management to establish internal controls on financial reporting).

[50] See Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission (draft dated Apr. 23, 2006), available at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport_d.pdf at 19-20.

a lack of empirical evidence that suggests a need for the extensive corporate governance legislation currently in place in Canada.

b) Empirical Studies

In the post-Enron era, one hears complaints that corporate executives are distracted from running the business while they fuss over corporate governance compliance issues. These complaints give rise to the position that the corporate governance pendulum has swung too far because the business of compliance often overshadows the operation of the business itself. Empirically there has been no causal relationship drawn between many of the governance mechanisms in place in Canada and firm performance. Indeed the academic literature on the relationship between governance and firm performance is mixed (e.g. Gompers et al, 2003; Black et al, 2006). In the Canadian context, no relationship has been found to exist (Klein et al, 2005; Jog and Dutta, 2004). Thus, before implementing additional corporate governance regulation, especially mandatory regulation, securities regulators should examine the relationship between particular corporate governance mechanisms and firm performance. Securities regulators should also indicate, through RIA, the bases on which the regulation is justified. Only then can it be determined with accuracy whether the pendulum has swing too far.

It is indeed arguable that the relationship between firm performance (as measured by stock price for example) and corporate governance is but one piece of the puzzle regarding what is in shareholders' best interests. A study by McKinsey & Company concluded on the basis of a 2002 survey conducted on 200 institutional investors that investors "still put corporate governance on [sic] par with financial indicators when evaluating investment decisions." Certainly discussions that Lynnette Purda, Frank Milne and I had with Canadian institutional investors support this point.[51] Thus, while statistical analysis is an important aspect of analyzing corporate governance regulation, study over and above statistical analysis is necessary to determine the extent to which corporate governance mechanisms are desired and needed by shareholders. Surveying retail and institutional investors directly is one such way to ascertain the perceived benefits of regulation. RIA or formal cost-benefit analysis is another means.

Empirical data will assist in the assessment of whether the pendulum *may* have swung too far to the side of too much regulation in the corporate governance area. Also, empirical evidence may shed light on the contention that ever-increasing disclosure requirements have an inverse relationship with the utility of

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[51] These discussions occurred in January 2005 with various institutional investors in Canada whose anonymity we agreed to respect during the course of our discussions. See Anand et al (2006).

such disclosures (See Clark, 2005). It may seem that nonrepetitive disclosure has valuable effects in enhancing market efficiency by reducing information asymmetries. In other words, if the disclosure requirements provide information which investors do not already have pursuant to another disclosure rule, the disclosure is worthwhile on the basis of informational efficiency rationale.

However, disclosure requirements should not be sanctioned simply because they may have the effect of reducing information asymmetries. Because disclosure is not costless, in each case we must ask whether the costs of the disclosure outweigh the benefits that arise from the additional disclosure that will be made. If, for example, only 2% of investors are interested in the information in question, while the other 98% would deem it irrelevant to their investment decisions, and there is a cost associated with the issuer's disclosure, the aggregate benefits of the increased disclosure would not outweigh the costs of providing it (see Deaves, 2006).

The decreasing utility of disclosure requirements does not negate the necessity for mandatory disclosure in all cases. As noted above, there are sound reasons for maintaining a mandatory disclosure system, including those relating to informational efficiency. However, admitting the centrality of mandatory disclosure does not mean that one must also endorse each and every disclosure requirement. Because of issuer costs associated with making disclosure, it is important to view each proposed new disclosure rule as an initiative that must be subject to formal CBA or RIA like any other proposed rule.

Recommendation #15: It is necessary to discern the extent to which Canada's corporate governance regime, which contains extensive disclosure and compliance obligations, is indeed important and beneficial for investors/shareholders. To this end, further studies should be commissioned or undertaken by securities regulators with regards to whether there is a relationship between firm performance and particular governance mechanisms in place in Canada.

Recommendation #16: Justification of corporate governance laws should be based on RIA or formal cost-benefit analysis that outlines benefits and risks of the regulation as well as alternatives.

c) Voluntary Compliance

Firms have incentives to behave voluntarily in the corporate governance area. If the benefits of voluntary behaviour exceed the net costs, firms are likely to behave voluntarily. Firms may adopt voluntary governance practices to deter investors from devaluing them (Ross, 1979). In addition, firms will seek to prevent network externalities that could occur if they do not adopt governance practices, including disclosures, that are otherwise the norm. They will seek to ensure that they do not support a governance structure that is unfamiliar to investors. Otherwise they risk being seen as an outlier and raising capital may be difficult.[52]

A recent study by Anand, Milne and Purda (2006) documents a general increase in the voluntary adoption of governance practices. In this study, data was collected from proxy circulars of about 200 firms on the TSX/Standard and Poor's (S&P) Index from 1999-2003. Two issues were examined: the behaviour of Canadian companies under the best practices regime, and the impact of U.S. governance requirements on Canadian firms that are not listed on U.S. stock exchanges. In both instances, we found that there is no requirement for firms to adopt suggested governance guidelines, and yet the study found significant evidence that they do so voluntarily. In addition, the extent to which voluntary governance guidelines are implemented has increased considerably in recent years.

Specifically, the empirical results show that between the years 1999-2003, Canadian firms voluntarily implemented Canadian best practice standards as well as SOX-like governance mechanisms. Furthermore, the study identified certain firm characteristics that are associated with the adoption of the Canadian guidelines; these include the absence of a large executive block holding and a high need for external financing. In addition, firm size is an important determinant in terms of adopting SOX governance provisions. In particular, large, non-cross-listed Canadian firms showed a higher propensity to voluntarily adopt SOX provisions. This is perhaps not surprising since it is the largest Canadian firms that may be most in need of attracting capital from foreign investors. These are the issuers that may be preparing for cross-listings or who are raising capital in the U.S. already in the exempt market.

The results of the study bear out the postulation that firms act voluntarily with regards to corporate governance, and that entirely mandatory governance legislation may not be necessary, at least where certain incentives exist. Furthermore, the study raises the question of whether mandatory legislation is necessary, since firms clearly do act voluntarily in the corporate governance area. Why is this significant? Regulation can be less onerous if regulators take into account the propensity of issuers to behave voluntarily in devising and proposing new regulation. As Brent Aitken (2005), Vice Chair of BCSC states in support of the B.C. Model, "We prefer non-rule solutions, because rules are generally the

[52] Admittedly, investors will not always discount the value of a firm if they do not have information about its corporate governance practices. Investor scepticism will depend on many factors such as the disclosure history of the firm and the firm's performance (including its share price).

most intrusive and expensive form of regulatory intervention…. Rules can also have adverse effects, such as limiting competition, slowing innovation, increasing costs….” Recognizing incentives for voluntary behaviour is a non-rule or market-based solution that can, if acted upon, directly lessen the regulatory burden.

Some have argued that securities regulators cannot rely on market incentives because their strength ebbs and flows with bull and bear markets. While the certainty of market-based mechanisms depends to some extent on market conditions, this does not mean that the propensity for voluntary conduct should never be studied and relied on. For example, it appears that the TSX best practice guidelines have been successful in encouraging voluntary compliance over the past ten-year period, despite changing market conditions during this time. Furthermore, even in a mandatory system, compliance may be difficult to achieve especially if enforcement is not rigorous.

Recommendation #17: Regulators should be cognizant of market-based incentives that encourage compliance with a best practice regime based on voluntary standards and utilize market-based incentives when feasible in the implementation of corporate governance regulation.

d) Mandatory Disclosure

Admittedly, however, there is no *guarantee* of compliance in a system that relies on voluntary incentives. The tradeoff may be lower costs in a purely voluntary structure, but also lower compliance, while a mandatory structure is characterized by higher costs and perhaps higher compliance overall. Because of potential difficulties regarding compliance in a purely voluntary regime, this report favours a partially enabling or hybrid structure where, like the regimes in Canada, the United Kingdom, and Australia, the adoption of governance practices is optional but disclosure regarding governance practices is mandatory. This structure is likely to yield a high level of compliance at lower cost than a wholly enabling or wholly mandatory regime.

Mandatory disclosure is necessary because it heightens compliance with an otherwise voluntary regime by attaching consequences to firms' decisions not to disclose negative information (Easterbrook and Fischel, 1984).[53] If a firm knows that the market is watching its governance practices, it will have a

[53] These authors state "In a world with an anti-fraud rule but no mandatory disclosure system, firms could remain silent with impunity. If they disclosed, they could do so in any way they wished, provided they did not lie. . . . A mandatory disclosure system substantially limits firms' ability to remain silent."

greater incentive to comply with the voluntary guidelines that investors deem desirable.[54] A disclosure requirement reduces information asymmetries by giving investors a minimum amount of information on which to base their investment decisions. It also controls other variables, such as the time, place, and manner of the disclosure (Easterbrook and Fischel, 1984), thereby ensuring that information will be conveyed to investors in a standardized manner. Mandatory disclosure also can reduce conflicts between directors, managers, and other agents (Mahoney, 1995) since they likely all have an interest in avoiding negative disclosure that may hurt the firm as a whole. Finally, mandatory disclosure provides some resolution to the credibility problem whereby managers make only self-serving voluntary disclosures (Healy and Palepu, 2001; Seligman, 1983; Bainbridge, 2000).

Recommendation #18: Given the role of disclosure in decreasing information asymmetries, mandatory disclosure should be a central component in an otherwise voluntary corporate governance regime.

e) Plain Language

Admittedly, problems with a mandatory disclosure system include the extent to which disclosure is incomprehensible to investors. The issue of plain language - or plain English as it is sometimes termed - in disclosure documents has received significant attention in the U.S. In 1998, the SEC adopted plain English disclosure rules (for both corporate issuer prospectuses and mutual funds prospectuses) and a new disclosure option for mutual funds.[55] These rules were designed to lead to a better-informed securities market in which investors can more easily understand the disclosure required by the federal securities laws.[56] The SEC reports that the plain English disclosure rules for issuers, although initially challenging to adopt, have been successful in their implementation for both corporate issuers and mutual fund

[54] Each year, one of Canada's leading national newspapers, the Globe and Mail, conducts a review of corporate governance practices for companies listed in the benchmark S&P/TSX index, based on a ranking of its own devising, in the "Board Games" series (McFarland, 2003). The 2004 Board Games series suggests that firms' voluntary adoption of corporate governance practices is, in part, a response to the previous Board Games rankings.
[55] Securities and Exchange Commission, "Plain English Disclosure" (1998) Release Nos. 33-7497; 34-39593; IC-23011.
[56] The plain English disclosure rules require issuers to write the cover page, summary and risk factors sections in plain English using short sentences; definite, concrete, everyday language; active voice; tabular presentation or bullet lists for complex information; no legal jargon or highly technical business terms; and no multiple negatives. Rule 421(b) requires issuers to ensure that the entire prospectus is clear, concise, and understandable. This is in addition to Rule 421(d) which only applies to the front of the prospectus. Certain techniques are required, including presenting information in clear, concise sections, paragraphs, and sentences; using descriptive headings and subheadings; avoiding legal and highly technical business language. As well, amendments were made to various regulations that govern particular aspects of the prospectus. In order to assist issuers, the Commissioner's Investor Education Office published a "Plain English Handbook, How to Create Clear SEC Disclosure Documents" which provides advice to issuers (SEC, 1998).

prospectuses.[57] (Glassman, 2005) Other jurisdictions – such as the United Kingdom, the European Union and Australia – have also endorsed plain language initiatives to varying degrees (Sarra, 2006).

By contrast, plain language has received intermittent attention in Canada, with no equivalent to the SEC's initiatives in this area. The CSA have mentioned "plain language" and "plain English" requirements or suggestions in some but not all of its mandatory disclosure rules, forms and companion policies, including in forms relating to AIFs in the mutual fund area[58] and the Fair Dealing Model Concept Paper (OSC, 2004b). The threshold for plain language seems to be that language must be clear,[59] but suggestions contained in legislation such as "use the active voice", "avoid jargon" and "avoid multiple negatives" would likely be difficult to enforce. Would regulators refuse to accept an AIF (or a short - form prospectus into which the AIF was incorporated by reference), if the disclosure failed the plain disclosure test?[60] A further issue in Canada relates to the country's two official languages: plain language in English may not be the same thing as plain language in French.

The Investor Education Fund has examined the level of understanding that investors require to comprehend typical disclosure documents, and has found that investors' literacy skills are below the standard necessary to understand these documents.[61] In deciding whether and to what extent plain language should be incorporated into the legislative scheme, we need to explore the appropriate levels of responsibility of various stakeholders. Should issuers solely bear the duty to ensure that disclosure is readable from the perspective of the retail investor? Is it the role of the regulator to monitor not only the substance of disclosure documents but also how readable they are? Should retail investors themselves bear some responsibility for understanding corporate disclosure, such as financial statements and MD&A? These questions suggest that at present it is not clear who - the regulator, issuers or investors themselves - should bear the burden of ensuring that investors can understand disclosure or how this responsibility should be shared. Before endorsing plain-language initiatives in Canadian securities regulation, we must be certain of the parties upon whom we wish to impose additional responsibilities

[57] This Commissioner has reported that today, an issuer's prospectus (while still cumbersome and not always as informative as it could be) is far easier to read and understand as a result of this industry-wide revision.
[58] See Companion Policy 81-101 CP "Mutual Fund Prospectus Disclosure" (2000) 23 OSCB (Supp) 1 and (1999) 22 OSCB (Supp) 1 and amendments. The Stromberg Report on Mutual Funds recommended plain language in mutual fund disclosure.
[59] The standard may be language that helps "investors understand your disclosure so that they can make informed investment decisions…" See Companion Policy 51-102 CP "Continuous Disclosure Obligations" (2005) at s. 1.5.
[60] E-mail correspondence with Julia Dublin, Barrister and Solicitor, March 2, 7-8, 2006.
[61] This is the Test of Workplace Essential Skills (TOWES) Joint Venture with the OSC. TOWES staff prepared a report for the OSC's Investor education Fund in April 2002.

especially since requiring plain language would likely increase the compliance burden for issuers at least in the short term.

Despite these questions, most would agree that more plain language in disclosure documents would be a positive development. Disclosure is meant to decrease information asymmetries between issuers and investors and to prevent fraudulent offerings. As discussed above, markets become more informationally efficient with the disclosure of information. Plain language reduces informational asymmetries and improves the quality of disclosure and it is warranted on that basis. The fact that many investors invest through a dealer, and that Canada has a preponderance of controlling and institutional (i.e. sophisticated) shareholders, does not negate the necessity for plain language. Plain language can improve the quality of disclosure which should be a primary focus of securities regulatory authorities.

Thus, at this stage and prior to undertaking the further study referred to above, securities regulators should adopt a policy statement (rather than a rule) that sets forth guidelines for plain language in disclosure documents. This would assist in formalizing the view that plain language is an important part of corporate disclosure, without contributing to heavier regulation. Finally, it is important to note that legislative initiatives that emanate from regulators themselves should also fall within the purview of plain language principles. Plain language should apply not only to issuer's disclosure but to the drafting of securities legislation, including rules and policy statements, generally. The goal in all cases is to increase transparency.

<u>Recommendation #19:</u> This report endorses the principle of plain language. Further study is warranted on the appropriate division of responsibilities in ensuring that disclosure documents are readable, as it is not clear that issuers alone should bear this responsibility. Prior to this study being undertaken, a general policy statement rather than a rule should be issued, setting forth principles for plain language in all disclosure documents.

<u>Recommendation #20:</u> In drafting legislation, including rules, policy statements, and their comments to market participants, regulators should adopt the practice of communicating in plain language.

iv. Take-Over Bids

There has been a boom in mergers and acquisitions (M&A) over the past year. Thomson Financial reports that global M&A volume increased to U.S.$333.7 billion (Thomson, 2006) with more that U.S.$25 billion of Canadian deals in the first quarter of this year. From a legal standpoint, the take-over bid area is one in which there has been little amendment over the past thirty years or so relative to other areas of law. Under the comprehensive legislative regime, shareholders of the target have a variety of legal protections. These protections, most relevant in the hostile bid situation, ensure disclosure of relevant information (e.g. take-over bid circular), equality of treatment (e.g. identical consideration) and rights with regards to timing of the bid process (e.g. withdrawal rights). Many of these rules have been considered in the recent past by the Zimmerman Committee, a committee struck by the IDA to review take-over bid time limits among other things (Zimmerman, 1996). As a result of the Zimmerman Committee's comprehensive analysis, the Five Year Review Committee (2003) identified few areas of take-over bid regulation which required its consideration.[62] Building on these past reviews of take-over bid regulation (and not wanting to repeat thoughtful analysis contained therein), this section examines the following issues: the purpose of defensive tactics, duties of the board in a take-over bid and exemptions to the take-over bid requirements.[63]

a) Defensive Tactics

There is a view circulating that Canadian firms are more vulnerable to take-over bids because of Canada's securities law regime (McNish, 2006). This view begins with the position that Canadian take-over bid laws favour bidders because they do not have as many barriers to take-over bids as U.S. regulation. Generally speaking, defensive tactics in Canada are more restrictive than in the U.S. In the U.S., the poison pill can be used to thwart a bid for an extended period.[64] It is an insulating device that allows management essentially to reject, indeed refuse to consider, a hostile take-over bid. In Canada, on the other hand, the poison pill buys time for the target board to consider the take-over bid, search for alternative suitors or value maximizing options for the company. Poison pills in Canada typically have a limited duration (of 30-60 days). In short, boards in Canada cannot "just say no" to a take-over bid while in the United States, they have this option.

[62] See FYR, 2003 at 182. These issues included: arrangements vs. take-over bids, shareholder rights plans, break fees, partial bids, mini-tenders and convertible securities.
[63] See *supra* note 1 at part XX. For discussion of these principles, see also Condon, Anand and Sarra, 2005 at ch. 9.
[64] In the U.S., it is usual practice for a bidder to simultaneously launch a proxy fight to unseat the board in the event that they do not revoke the poison pill. This means that a poison pill can be used to thwart a bid for an extended period but not necessarily indefinitely.

The philosophy underpinning Canadian law appears to be that shareholders' interests are of primary concern. That is, shareholders, not the board alone, should ultimately decide the fate of the company by tendering to the bid (or not). The law seeks to uphold this principle, thereby preventing management entrenchment and facilitating take-over bids. This approach is appropriate in a country with a high concentration of ownership and a prevalence of controlling and institutional shareholders. If institutional shareholders are tendering, they are doing so likely because of a belief that the bid is properly valued. By contrast, where shareholdings tend to be widely dispersed, as in the U.S., it may make more sense to vest the board with a "just say no" defence since it may be difficult for shareholders to make a collective decision in any given hostile bid.

To explore this issue further, it would be useful to study and assess whether shareholders including institutional holders, can be coerced into tendering to sub par bids due to risks of limited liquidity or majority influence that may exist in the relatively highly concentrated and shallow Canadian capital markets. If these are found to be real concerns having a significant impact on Canadian markets, a reassessment of the take-over bid rules in Canada, and particularly the duties of directors in adopting defensive tactics, may be necessary.

We should note that it is not the role of securities regulation to support national interests – this is within the purview of federal legislation including the *Competition Act*[65] and the *Investment Canada Act.*[66] However, as argued below, securities regulation should aim to promote competitiveness and part of this objective includes ensuring that Canadian companies operate on a level playing field with their counterparts in the United States and indeed worldwide.

b) Directors' Duties

There is some ambiguity in Canadian law regarding the duties of the board in a take-over bid. Securities regulators, and particularly case law emanating from the commissions, seem to have adopted the position that once faced with a take-over bid, a board must maximize shareholder value. Courts have also taken this view. For example, in the 1998 decision of *CW Shareholdings Inc. v. WIC Western International Communication Ltd*.,[67] the General Division of the Ontario Court held that boards must seek to maximize

[65] *Competition Act*, R.S.C, 1985, c. C-34.
[66] *Investment Canada Act*, R.S.C. 1985, c. 28 (1st Supp.)
[67] *CW Shareholdings Inc. v. WIC Western International Communications Ltd.,*(1998), 39 O.R. (3d) 755 (Gen. Div.).

shareholder value by conducting an auction. Some practitioners advise their clients that maximizing shareholder value can mean "long-term" as opposed to "short-term" value and, indeed, this would be consistent with Canadian and U.S. case law. But practically speaking, this point is moot as the highest bid will likely win.

Recent judicial decisions raise questions regarding whether shareholder primacy should indeed be the law in Canada. In particular, in *Peoples Department Store v. Wise,*[68] the Supreme Court of Canada held that in discharging its fiduciary duty to the corporation, it may be legitimate for the board to consider the interests of any number of groups including "the interests of shareholders, employees, suppliers, creditors, consumers, governments and the environment." Previous decisions also suggest that shareholder maximization is not the law in Canada. In *Maple Leaf Foods Inc. v. Schneider Corp*,[69] for example, the target board (*Schneider*) accepted the bid from a preferred company (Smithfield Foods) as opposed to numerous increasing bids from the original bidder (*Maple Leaf*). The Ontario Court of Appeal held that the target board had not acted improperly in rejecting the Maple Leaf bid which was of higher monetary value than the Smithfield bid. Notably, the board's rationale in the case was that the Smithfield bid was the only viable bid available to shareholders (i.e. it was the only bid that the controlling shareholder was prepared to accept).

The question of directors' fiduciary duties has historically been one for the courts and not for securities regulators (notwithstanding National Policy 62-202[70] which is a policy rather than a rule). But, in light of recent case law, there is a need to consider and clarify whether the duty of the target board in a take-over bid is indeed to maximize shareholder value and the extent to which this position conflicts with existing judicial decisions. In particular, how does the *Wise* decision (and to a lesser extent *Schneider*) square with previous case law that suggests that the duty of the target board in a take-over bid is to maximize shareholder value (whether this be short-term or long-term value)?

<u>Recommendation #21:</u> In light of recent case law, securities regulators should consider whether the duty of the target board in a take-over bid is to maximize shareholder value and if so, how existing case law is to be reconciled with this duty.

[68] *Peoples Department Stores Inc. (Trustee of) v. Wise,* [2004] 3 S.C.R. 461.
[69] *Maple Leaf Foods Inc. v. Schneider Corp.* (1998), 42 O.R. (3d) 177 (C.A.).
[70] National Policy 62-202 "Take-over bids – Defensive Tactics" (1997) 20 OSCB 3525.

c) Exemptions

Take-over bid codes in Canada contain certain exceptions, such as: bids made through the facilities of a stock exchange (because these bids are regulated by the exchange); bids made in the “normal course” (where “normal course” means purchases of not more than 5% of the securities in a one-year period and the purchase price does not exceed the market price); and, bids for certain control blocks in private agreement with a limited number of persons (i.e. the “private agreement exemption). In particular, sale of a control block is permitted if the offer is made to five or fewer persons, it is not made generally to all shareholders of the class and the offer price, including brokerage fees and commissions, does not exceed the market price of the securities by more than 15%.

There is a clear policy choice in the private agreement exemption to limit the premium that can be gained on sales of control. The exemption attempts to balance two competing objectives: encouraging transfers of control and the efficiencies to be gained from doing so on the one hand, with treating shareholders equally on the other. The idea is that those with control should not be able to receive a “premium” for their shares simply because of their position of control. Indeed, the exemption may be driven by the view that control is a corporate asset that belongs to all shareholders (see Bayne, 1963; Andrews, 1965). While there is a long history relating to this exemption, including various industry reports, it was the report of the “Three Wise Men” (Coleman *et al.*, 1983) that stressed the need to treat all shareholders equally, even those shareholders that hold a controlling block, in a change-of-control situation:

> …we believe that shareholders of an offeree issuer and public investors generally should be confident that transactions which may affect the de facto control of public security issuers will be made, as a matter of principle, on a basis which requires identical treatment of holders of the same class of securities and that all such shareholders will have an equal opportunity to participate in the benefits which may accompany a change of effective control of issuers.

In take-over bid legislation generally, the principle of equality is present throughout the code, such as in the identical consideration provision and the pro rata take-up provision. The Three Wise Men’s Report assumed the existence of such a principle further stating, “We have…attempted to preserve competitive free market forces and capital flows within a climate which honours the principles of investor protection and equal treatment. These latter principles we consider essential for appropriate take-over bid rules”, (Coleman *et al.*, 1983).

To what extent is the notion of equality applicable in the context of the take-over bid exemptions? Does the exemption successfully “preserve market forces” while treating shareholders equally? There is no mention of the principle of equality in section 2.1 of the *Securities Act* (Ontario) which sets forth “principles to consider” in pursuing the purposes of the statute. Further, as is well-known in public law, “equality” bears many meanings and if it is a firmly entrenched principle in securities law, further elucidation of its role and place is necessary (Anand, 2000). It should be noted that because the private agreement exemption limits the price that can be obtained for one’s control block, it may have the effect of limiting transfers of control generally (see Gillen, 1998). This would be disadvantageous for target shareholders who themselves may benefit from a change of control.

Without an explanation of the rationale underlying the take-over bid exemptions, the extent to which an equality principle should be applied is unclear. In addition, the size of the premium that control block holders should receive when selling their shares is open to question. If a principle of equality alone does drive the exemption, then what is the rationale for the 15% premium - should it remain? Is this percentage the appropriate amount? On what basis should it be higher or lower? Admittedly, these matters are not in need of urgent attention. But they are questions that pervade the private agreement exemption which in turn relate to the frequency of change of control transactions generally.

<u>Recommendation #22:</u> Further regulatory consideration should be accorded to the 15% limitation in the private agreement exemption, whether this is the appropriate ceiling and whether it should be higher or lower. Greater transparency regarding the rationales underlying the exemption is warranted, especially with regards to the extent to which a principle of equality is enshrined therein.

7. <u>Competitiveness of Canadian Capital Markets</u>

Some might argue that the recent spate of corporate governance regulation, together with increased disclosure obligations and civil liability for misrepresentations in disclosure documents, together evidence of an imbalance between investor vs. issuer interests. There is some legitimacy to this view; the importance of maintaining the competitiveness of Canadian capital markets at times appears buried in the effort to ensure that investors' interests are protected. However, this trend was not entirely unjustified in the post-Enron era where market confidence was impacted by public company scandals. Furthermore, it is not the case that securities regulators uniformly overlook efficiency and concerns regarding competitiveness. One need only examine recent reforms to the short form offering rules and the reduction of restricted periods in the exempt market as examples. Nevertheless, questions persist: why does it appear that capital markets are so heavily regulated? Is such regulation necessary? And, what are the resulting effects of securities regulation on Canada's competitive stance globally?

i. Competitiveness as an Element in Balance

Balance is important not only to ensure that investors are protected as issuers undertake a variety of transactions but also to ensure that markets remain competitive. There is thus a global aspect to the question of balance which is that Canadian capital markets need to remain competitive with markets in other jurisdictions. In its submission to the Five Year Review Committee, the IDA commented as follows:

> In today's increasingly competitive and global markets, a small capital market risks marginalization with negative consequences for issuers and investors. Domestic fairness and efficiency, while core objectives, are inadequate, if the market cannot respond to competitive inroads which force or encourage both the buy side and the sell side to go elsewhere, or be deprived of capital or investment opportunities.[71]

In a very real sense, therefore, the question of balance between issuers' and investors' interests is irrelevant if Canadian markets are not competitive. The interests of both issuers and investors will suffer if our markets, and the regulation that governs them, repel rather than invite capital raising and investment avenues. Investors lose because their investment opportunities in this country decrease. Issuers lose because the costs of remaining in Canada are high relative to those in deeper, more liquid markets.

[71] Comment Letter of the IDA to the Five Year Review Committee (June 12, 2000).

ii. Characteristics of Canadian Capital Markets

Canadian capital markets begin at a disadvantage because of Canada's small population, the limited market depth of capital in these markets, and the small proportion of widely traded companies compared to companies that have a controlling or large institutional shareholder. Without question, it is difficult for Canada to compete given these particular characteristics.[72] The structure of Canada's regulatory regime, consisting of thirteen separate securities regulators, surely adds to the difficulty in attaining a competitive position globally. Apart from these seemingly obvious factors that affect Canada's competitive stance, does a heavily regulated securities market also impact the competitiveness of Canadian firms and the Canadian economy generally?

A level of investor protection laws serves to enhance the operation of the capital markets. This is an important finding of LLSV (2002): markets with comprehensive investor protection laws including private enforcement through disclosure and liability rules are deeper and more liquid. However, while LLSV examined legal rules protecting the rights of investors, they concentrated on minority shareholder protections found in corporate statutes, including: voting rights attached to shares (such as one share per vote), shareholder voting procedures such as whether voting by proxy is permitted; ability for shareholders to deposit their shares with the company or financial intermediary prior to the shareholder meeting; cumulative voting for directors; ability of shareholders to sue directors such as under the oppression remedy or derivative action, etc. In other words, although the conclusions of LLSV are broadly relevant here, the authors did not specifically engage in an analysis of the investor protection mechanisms found in securities regulation per se.

This is not to say that investor protection laws in the securities regulatory sphere are unimportant. On the contrary, it seems to be accepted wisdom that investor confidence and market integrity depend on the existence of such laws. But the question is: at what point do investor protection laws impede competitiveness? Of course, this is an impossible question to answer definitively. But law has some ability to enhance competitiveness by making it easier for foreign and domestic issuers to access capital markets. This is why rules relating to the exempt market and public offerings are so crucial in the overall balance between issuers and investors. In each case of rule-making, the regulator must ask if this rule enhances the ability of the issuer to get to the market quickly without undermining investor protection

[72] Though not within the mandate of this paper, another important issue relates to what products Canada should compete for given its comparative advantages and disadvantages on the world stage.

concerns in the process. The regulatory decision-making process must be seen at all times to be a trade-off among values and not simply the choice of one value over another.

A further question is the degree of harmonization with U.S. laws that is desirable. Without question, Canada's relationship with the U.S. and Canada's foreign investment laws have impacted the growth of securities markets over the past decades. Canada has a history of protectionism dating back to the National Policy of 1879 (Daniels and Iacobucci, 2000). Notably, Canadian investment portfolios were subject to the foreign property rule which limited the amount of foreign assets an investor could hold in their RRSP to twenty percent of the book value of the total portfolio.[73] Also in place are the *Competition Act*[74] and the *Investment Canada Act*[75] which regulate mergers and acquisitions and the effects of foreign investment in Canada. Thus, the competitiveness of the Canadian economy is affected by many laws outside of securities legislation.

Yet securities regulation certainly impacts the competitiveness of Canadian capital markets. Lack of harmonization in the securities regulatory structure has been said to deter foreign issuers from raising capital in Canada (Wise Persons', 2003). Further, while domestic capital raising rules have generally become more liberal, compliance with corporate governance and continuous disclosure obligations have become more onerous as discussed above. Generally speaking, in order to maintain the competitiveness of Canadian issuers with those in other jurisdictions, securities regulation should generally be harmonized with international and particularly U.S. rules. As noted above, in all cases, harmonization may not be possible or appropriate given the distinctive characteristics of Canadian capital markets. But prima facie, it should be an objective at the forefront of the regulatory consciousness. It is important to note the difference between harmonization and uniformity. Harmonization implies similarity of purpose but does not, like uniformity, require precisely the same rules to be implemented. It is possible to harmonize legislation with that in other jurisdictions while taking into account distinctive features of the Canadian regulatory regime. The CSA rules relating audit committee composition and financial certification rules are cases in point.

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[73] This rule was repealed in February 2005 but while in place, had the effect of preventing diversification. As a Fraser Institute paper has stated, "It is clear that the FPR imposes huge costs on individuals through both reduced diversification and a reduction in the rates of return garnered from savings. The magnitude of foregone capital accumulation of investors in Canada, coupled with the material need to augment public social security benefits in order to maintain a reasonable standard of living in retirement, combine to form a solid rationale for eliminating the Foreign Property Rule." (Fraser Institute, 1999)
[74] *Supra* note 67.
[75] *Supra* note 68.

iii. MJDS Case Study

The advantages of harmonization can be seen readily with the Multi-jurisdictional Disclosure System (MJDS). Under MJDS, eligible Canadian issuers can offer securities to the public in the U.S. using a prospectus that adheres to Canadian regulation. The document is filed and reviewed by Canadian securities regulators. Similarly, eligible U.S. issuers wishing to complete a cross-border offering in Canada need only file a registration statement with the SEC to offer securities in Canada. The SEC reviews the document and the offering can proceed without approval from Canadian regulators.[76] Thus, under the MJDS, issuers do not need to clear their offering documents with a foreign regulator even though they are raising capital in a foreign country. A list of MJDS transactions compiled by the author indicates that between 1991-2003, Canadian issuers completed about 527 transactions in the United States under the MJDS.

The academic literature frequently refers to the MJDS as an example of mutual recognition, because each country abides by and accepts the disclosure laws of another country.[77] Yet when the SEC originally contemplated rules to facilitate multinational securities offerings, it proposed two conceptual approaches: a reciprocal approach and a common prospectus approach.[78] The reciprocal approach would be an agreement between the U.S., Canada and the United Kingdom, under which a prospectus accepted in an issuer's home country would be accepted in the other countries providing it met certain standards. The common prospectus approach was a form of disclosure document that would be approved by all three countries. The SEC thought that these approaches would lead to increased harmonization.[79] The MJDS was explicitly a hybrid of these two approaches.[80] Thus, the MJDS was intended to include an element of harmonization over and above mutual recognition of differing disclosure laws.

The MJDS story indicates the advantages of harmonization, especially in enabling Canadian issuers to access the larger and deeper capital markets south of the border. Harmonization has a direct impact on

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[76] The Canadian law is set forth in National Instrument 71-101 "The Multi-Jurisdictional Disclosure System" (1998), 21 OSCB 5104. See also National Instrument CP 71-101 (1998), 21 OSCB 5089 and OSC Rule 71-801 (1998), 21 OSCB 6919. The U.S. law is set forth in 56 Fed. Reg. 30036 (1991) and reproduced in Rule 71-801.
[77] Other examples of reciprocal delegation include two EU directives relating to securities offerings. See Directive 2001/34/EC, 2001 OJ (L184) and Council Directive 89/298/EEC, 1989 OJ (L 124) cited fully in Tung, 2002.
[78] Securities and Exchange Commission, Release No. 6568, Release No. 33-6568, 32 S.E.C. Docket 707, 1985 WL 634782, 17 CFR Part 230 "Facilitation of Multinational Securities Offerings," File No. S7-9-85 (February 28, 1985).
[79] SEC Release No. 6568, Release No. 33-6568, ibid.,
[80] As the SEC stated, "While the multi-jurisdictional disclosure effort is based on the concept of mutual recognition, Canada was chosen as the first partner for the United States in part because of the similarities between the U.S. and Canadian investor protection mandates and disclosure standards." Release No. 2254, Release No. 6879, Release No. 28561, Release No. 33-6879, Release No. 1 "Multi-Jurisdictional Disclosure and Modifications."

competitiveness and growth of the Canadian economy. However, this is not to say that in all cases securities law in Canada should, as a matter of fact, be uniform with U.S. law. Rather, harmonization as an objective should occur as part of an analysis of the distinctive aspects of the Canadian regime. Without endorsing the current balance in corporate governance regulation, it bears noting that securities regulators undertook this type of analysis in the aftermath of *Sarbanes-Oxley*. In proposing the recent B.C. model, the BCSC also endorsed regulatory solutions that account for the distinctive features of the Canadian regime.

iv. The Role of Law

Law has the ability to impede and enhance the efficiency and competitiveness of capital markets. Currently in the *Securities Act* (Ontario), neither the objectives nor the principles to which the OSC shall have regard in pursuing the purposes of the Act say anything about competitive regulation. The principles that are to be used in pursuing the purposes of the statute deal with disclosure, fraud, high standards of fitness and business conduct, enforcement, SRO expertise, responsible harmonization and co-ordination of securities regulatory regimes and costs that are proportionate to the regulatory objectives sought to be realized.[81]

U.S. securities legislation advances the objectives of competition (not competitiveness specifically) and formation of capital. The U.S. *Securities Act of 1933* states, “Whenever…the Commission is engaged in rulemaking and is required to consider or determine whether an action is necessary or appropriate in the public interest, the Commission shall also consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”[82] An almost identically worded provision is contained in the *Securities Exchange Act of 1934*.[83] However, neither Australia’s *Securities and Investments Commission Act 1989*[84] nor the U.K.’s *Financial Services and Markets Act 2000*[85] contains a specific reference to the need for regulators to promote competition in the purposes sections of the respective statutes.

There is a strong rationale for emphasizing the importance of capital raising and enhancing competitiveness in Canadian securities legislation. That is, Canada’s capital markets occupy a relatively

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[81] *Ibid.,* section 2.1.
[82] *Securities Act of 1933,* 15 U.S.C. *77*, section 2(b).
[83] *Securities Exchange Act of 1934*, 48 Stat. 881
[84] *Australia’s Securities and Investments Commission Act 1989* (Cth.).
[85] *Financial Services and Markets Act 2000* (U.K.), 2000, c.8.

insignificant percentage of global capital markets. Unless securities regulators consistently aim to enhance the competitiveness of Canadian markets, these markets will be marginalized as issuers turn to deeper, more liquid markets that are, legally speaking, easier to access. While securities regulators may seek to enhance the competitiveness of Canadian capital markets implicitly, the importance of this objective should be made explicit in the legislation.

v. Recommendation

Recommendation #23: The mandate of securities regulators should include a commitment to maintaining the competitiveness of Canadian capital markets with global markets.

8. Balancing Issuers' Interests with Investors' Interests

One question not yet addressed is whether balance among issuers and investors is an end in itself or a means to an end. We must think about balance in the context of the objectives of securities regulation and aim to achieve balance as a means to uphold these objectives. Viewed in this way, achieving balance is primarily a means to an end. I would argue that if there is an imbalance, it stems from a regime that has become increasingly investor-centered. While protecting investors should without question continue to be a goal of securities regulation, striving towards greater market efficiency and competitiveness of Canadian capital markets must also be at the forefront of the regulatory agenda. Considering the methodologies discussed above, a focus on investor protection or market efficiency would be justified if, based on a regulatory impact assessment, the resulting negative consequences were outweighed by the benefits of those circumstances and the risks to market participants were minimal.[86]

While this report did not assess balance in terms of the entire regulatory regime, it did analyze four areas of substantive law: public offerings, the exempt market, corporate governance and take-over bids. This part of the analysis gave rise to the first of three strands of recommendations:

- a more formalized and consistent system of monitoring issuers' disclosure is required before offering rules are liberalized;
- in the corporate governance area, securities regulation should take into account issuers' propensity to behave voluntarily (i.e. their market-based incentives);
- aspects of the closed system, such as resale restrictions, are outdated in an area of integrated, comprehensive secondary market disclosures;
- exemptions from the prospectus requirement need to be further streamlined and should be based on a "sophistication of the investor" rationale as opposed to on a "relationship to the issuer" rationale; and

[86] An assessment of the costs, benefits and risks of the entire securities regulatory regime is beyond the scope and indeed not within the mandate of this project. However, an observation regarding measurement: costs to issuers are much more readily observable than benefits to investors. But empirical analyses can assist in probing both of these issues. For instance, ultimately investors care about rates of return which are often measured by share price movements. Thus, benefits to investors can be measured at least in part by examining an issuers' stock price prior to and after the implementation of a regulatory initiative (i.e. an event study). Of course, the relationship between the implementation of the regulation and the stock price is correlative rather than causal. But this is one type of information that regulators could seek. In addition, from the issuer standpoint, it is possible to ascertain the number of new listings that other jurisdictions have relative to Canada. If the number of new listings in this country is significantly lower than in others, perhaps this is a reflection of the stringency of our regulatory system.

- take-over bid rules currently contain an appropriate balance in the law relating to defensive tactics; however, directors' duties in a take-over bid are unclear.

The second strand of recommendations relates to the role of the regulator: what can the regulator do to ensure that an appropriate balance is maintained between market efficiency and investor protection objectives? To address these questions, this report has recommended that regulators should:

- take into account the distinctive aspects of Canada's securities regulatory regime (e.g. preponderance of controlling shareholders and small- to mid-size cap firms), but aim to harmonize securities regulation with U.S. and/or international standards after doing so;
- clarify the terms "efficiency" and "investor protection" and the sense in which they are being considered and applied when issuing notices and requests for comments about proposed rules;
- consider costs and benefits but also the regulatory impact of proposed regulation on market participants. RIAs should be utilized and should include risk analysis as well as an assessment of viable alternatives to achieve the proposed objectives;
- employ empirical evidence when justifying regulation and employ sunset clauses where feasible;
- not allow the regulatory regime to remain loaded on the front-end without having back-end enforcement techniques in place; and
- utilize and recommend plain language disclosure and avoid patchwork regulation (as is found in the exempt market).

The third strand of recommendations in this report deals with the competitiveness of the Canadian capital markets. How do we ensure that competitiveness is part of the regulatory picture? Excessive, unharmonized regulation stands to hinder competitiveness in terms of domestic and foreign issuers wishing to remain public in this country and wishing to raise capital here. Because Canadian markets occupy an insignificant percentage of global capital markets, it is imperative that securities regulators at all times seek to ensure the competitiveness of our capital markets. Thus, this report recommends enshrining an objective to this effect in securities legislation.

In analyzing the level of competitiveness of the Canadian capital markets at any given time, empirical tests will need to be conducted. For instance, it would be useful to ascertain whether the number of going-private transactions has increased over the past decade. Has the rate at which domestic and foreign issuers listing on Canadian exchanges increased or decreased? Has the number of public offerings declined in recent years relative to the number of going-private transactions? These and other issues require further study. Indeed, one of the main themes of this report is that empirical data should be used to ground securities regulation. This report is a precursor to such empirical studies. It highlights the importance of empirical research and it identifies various areas in which such further study is warranted.

To return to the theme that opened this report: what should be done about a regulatory regime that is dense, complicated and increasingly voluminous? All of the recommendations in this report either directly or indirectly address this issue. For example, market-based incentives can in certain cases, such as the corporate governance area, effectively replace mandatory law. Furthermore, specifying the conception of efficiency and focusing on plain language in rule-making would contribute to easing the regulatory burden and render securities regulation more comprehensible. Finally, sunsetting regulation where feasible would, over time, allow regulators to dispense with rules that proved ineffective, thereby trimming the regulatory blanket.

While this report contains a number of recommendations, it should be remembered that generally speaking, the securities regulatory regime in Canada functions effectively under a comprehensive system of regulation. There are areas, however, in which the regulation could be more effective in balancing issuers' and investors' interests; some of these areas have been the focus of the foregoing discussion. Importantly, an appropriate balance between stakeholder interests depends not only on the substantive law but also on the way in which existing law is administered and enforced. Thus, these recommendations by necessity speak to the regulation *and* the regulator. It must be remembered that any balance that is achieved will not be static. Rather, it will need to be constantly assessed with subsequent regulatory adjustments being made.

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Glossary of Terms

AI	**Accredited Investor**
AIF	**Annual Information Form**
ASC	**Alberta Securities Commission**
ASX	**Australia Stock Exchange**
AMF	**Autorité des Marchés Financiers**
B.C. Model	**Proposed Model of Securities Regulation in *Securities Act*, S.B.C 2004, c. 43 (not currently in force)**
BCSC	**British Columbia Securities Commission**
CBA	**Cost-Benefit Analysis or Cost-Benefit Analyses**
CHIE	**Closely Held Issuer Exemption**
CSA	**Canadian Securities Administrators**
EMH	**Efficient Markets Hypothesis**
FSA	**United Kingdom Financial Services Authority**
FYR	**Five-Year Review Committee**
IDA	**The Investment Dealers' Association of Canada**
IOSCO	**International Organization of Securities Commissions**
IPO	**Initial Public Offering**
KH	**Kaldor-Hicks Efficiency**
Kimber Report	**Report of the Attorney General's Committee on Securities Legislation in Ontario**
LLSV	**La Porta, R., F. Lopez-de-Silanes, A. Shleifer & R. Vishny (see references section)**
MD&A	**Management Discussion and Analysis**
MFDA	**Mutual Fund Dealers' Association**
MJDS	**Multi-Jurisdictional Disclosure System**
MRRS	**Mutual Reliance Review System**

NASAA	**North American Securities Administrators Association**
OMERS	**Ontario Municipal Employees Retirement System**
OSC	**Ontario Securities Commission**
PO	**Pareto Optimality**
RIA	**Regulatory Impact Assessment**
RS Inc.	**Market Regulation Services Inc.**
PREP	**Post-Receipt Pricing Prospectus**
S&P	**Standard and Poor's**
SEC	**U.S. Securities and Exchange Commission**
SEDAR	**System for Electronic Document Analysis and Retrieval**
SEDI	**System for Electronic Data on Insiders**
SOX	**U.S. Sarbanes-Oxley Act of 2002**
SRO	**Self-regulatory organization**
Task Force	**The IDA Task Force to Modernize Securities Regulation in Canada**
Teachers	**Ontario Teachers Pension Plan Board**
TOWES	**Test of Workplace Essential Skills**
TSX	**The Toronto Stock Exchange**
WKSI	**Well-known seasoned issuer**

Appendix 1:

The following is the question posed to the researcher by the IDA Task Force on Securities Regulation:

> What is/should be the appropriate balance between issuers' interests and investors' interests in securities regulation? This research study will explore the appropriate balance between protecting investors and enhancing market efficiency. It will examine whether there is indeed a polarization between investor friendly and issuer friendly regulation, or whether one complements and/or enhances/impedes the other. Does a jurisdiction which provides strong investor protection mechanisms also, in so doing, enhance the efficiency of the capital market? In addition to other areas of securities legislation, this study will survey exemptions to the prospectus requirement across jurisdictions and analyze the extent to which they are issuer and/or investor friendly. How does exempting issuers from certain regulatory requirements on the basis of the knowledge, sophistication and/or wealth of the investors meet the criteria of issuer and/or investor friendly legislation? Has Canadian securities regulation achieved the right balance between investor and issuer friendly legislation? If not, how can the system be improved?

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