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Submission to the Task Force to Modernize Securities Legislation in Canada

By David Longworth and Donna Howard

The Bank of Canada appreciates the opportunity to provide our views on issues of mutual interest that the Task Force to Modernize Securities Legislation in Canada is examining.

The Bank strongly agrees with the Task Force's goal to achieve a dynamic, fair, efficient, and competitive capital market in Canada. We believe an efficient financial system is crucial for economic growth, as it enables investors to maximize the risk-adjusted returns on their investments and allows firms to minimize the costs of raising capital. An efficient financial system contributes to the effective allocation of resources and enhances the asset price formation process. As such, the market valuation of investment projects will reflect their actual underlying risk and return profiles, enabling savers to allocate funds to the type of investments that most closely match their desired risk-return preferences.[1]

One of the objectives of the Bank of Canada is to promote safe, sound, and efficient financial systems, both within Canada and internationally. The Bank of Canada has sought to contribute to the goal of an efficient financial system in a number of ways. The Bank's monetary policy aims to keep inflation low, stable, and predictable. By doing so, we enhance Canadians' confidence in the value of their money, thus reducing the need for people to spend resources either anticipating or coping with inflation. We also contribute to efficiency through our role as overseer of major payments, securities, and foreign exchange clearing and settlement systems, and by providing liquidity in times of financial stress.[2] By reducing risks to the safety and stability of the financial system, we increase certainty about the robustness of the financial system, thus supporting efficiency. Our semi-annual *Financial System Review* promotes awareness of financial system issues, looks at developments and trends in the system, and addresses issues that affect its safety, soundness, and efficiency. As well, the Bank works actively with market participants and regulators to develop and promote an efficient financial system. And we conduct research that helps inform the decisions of policy-makers as they strive to achieve greater stability and efficiency of the Canadian financial system.[3]

The Task Force to Modernize Securities Legislation in Canada is analyzing a number of issues that are of interest to the Bank of Canada including balancing cost and effectiveness of modern governance, access to capital, regulatory burden, and enforcement issues.

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[1] For a more detailed discussion about efficient markets, see Gregory Bauer "A Taxonomy of Market Efficiency, " *Bank of Canada Financial System Review*, December 2004.

[2] As fiscal agent for the Government of Canada, the Bank directly participates in fixed-income and foreign exchange markets. Efficient financial markets facilitate the attainment of the government's objectives of minimizing debt-issuance costs and minimize the costs and risks associated with holding foreign exchange reserves.

[3] Remarks by David Dodge, Governor of the Bank of Canada, to the Toronto CFA Society, Toronto, Ontario, 22 September 2005.

1. Balancing Cost and Effectiveness of Modern Governance

Information asymmetries that can lead to market failures arise when there are significant differences in the quantity or quality of relevant company information available to market participants. Therefore, in order to enhance efficiency, regulation should be designed to reduce these information asymmetries by encouraging disclosure of relevant information. However, it is important that regulation should aim to reduce information asymmetries only to the point that the benefits of disclosure still outweigh the costs of compliance.

Following corporate scandals such as Enron and WorldCom, too much attention has been paid to detailed rules that govern how companies disclose information, rather than focusing on what they disclose. This has resulted in a large increase in the costs of providing information, particularly in the United States, without commensurate progress towards improving the relevance of the information being disclosed.[4]

An example is the Sarbanes-Oxley Act introduced in the United States in July 2002. The Act sets new standards for corporate governance, accounting, and financial reporting for firms registered with the U.S. Securities and Exchange Commission (SEC). The most contentious element of Sarbanes-Oxley is Section 404 which requires a management assessment report and an auditor attestation report on the effectiveness of the firm's internal controls over financial reporting. The SEC's initial estimate for implementing Section 404 of Sarbanes-Oxley was around $1.24 billion (or $91,000 per company).[5] However, anecdotal evidence suggests that implementation costs are far higher than initially estimated, particularly for smaller firms.[6] In March 2005, Financial Executives International (FEI) surveyed 217 public firms with average revenues of $5 billion to gauge Section 404 compliance costs. The survey found that the average cost of compliance for the firms was about $4.36 million and that 94% of all respondents believe the costs of compliance exceed the benefits.[7] Academic studies also suggest that compliance costs are much higher than anticipated. A frequently cited academic study by Zhang (2005) examines market reactions around the legislative events prior and subsequent to the passage of Sarbanes-Oxley and estimates that the total cost of compliance is about $1 trillion (of which direct compliance costs are estimated to be $260 billion).[8] Another study by Carney (2005) that examines smaller firms (with median gross revenues of $25 million) finds that compliance with Sarbanes-Oxley increased firms' total compliance costs by 149%.[9]

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[4] Remarks by David Dodge, Governor of the Bank of Canada, to the Empire Club of Canada and the Canadian Club of Toronto, Toronto, Ontario, 9 December 2004.
[5] "Final Rule: Management's Reports on Internal Control over Financial Reporting and Certification of Disclosure in Exchange Act Periodic Reports", Securities and Exchange Commission, 5 June 2003.
[6] Lorie Zorn, "Corporate Financial Reporting: The Regulatory Response in the United States and Canada", *Financial System Review*, Bank of Canada, June 2005.
[7] "Sarbanes-Oxley Compliance Costs Exceed Estimates", Financial Executives International, Press Release, 21 March 2005.
[8] Ivy Xiying Zhang, "Economic Consequences of the Sarbanes-Oxley Act of 2002", AEI-Brookings Joint Center for Regulatory Studies, June 2005.
[9] William Carney, "The Costs of Being Public After Sarbanes-Oxley: The Irony of 'Going Private'", *Emory Law and Economics Research Paper Series* 05-4, February 2005.

The general principles behind the Sarbanes-Oxley law promote good governance and financial practices, but the extreme level of detail in the application of its rules, as well as its focus on process instead of outcomes, creates costs for many firms that likely exceed the benefits to the system. According to a study by the European Corporate Governance Institute, "the only aspects of Sarbanes-Oxley that are consistent with what should have been done [to enhance the effectiveness of securities regulation] are the increase in penalties for corporate fraud and the change in who appoints external auditors."[10] Under the new law, external auditors are appointed by the audit committee (formed only of independent directors) instead of by the CEO.

Large Canadian corporations that want access to U.S. capital markets have no choice; they must follow both the spirit and the letter of Sarbanes-Oxley.[11] But smaller, less-complex firms, which make up the vast majority of publicly listed companies in Canada, may not want to raise capital abroad. So it may not make sense for Canadian regulation to force these smaller firms to comply with the kinds of detailed rules that would be more appropriate for large firms. The Canadian Securities Administrators (CSA) recognized this point by proposing a phased approach for internal control requirements based on the issuer firm's size.[12] Moreover, we support the CSA's decision to delay implementation for internal control reporting requirements for firms in order to allow more time to assess the potential impact on companies of U.S. developments and to consider comments received on the proposed requirements during the CSA consultations.[13]

It is important that Canada's regulatory framework be guided by fundamental principles that are as good as, or better than, those of other countries. But Canadian rules and their application should be tailored to our domestic needs and should reflect realities that take into account differing levels of firm size and complexity.

2. Regulatory Burden

Regulation should encourage proper behaviour without imposing an unnecessary burden on participants through detailed rules and high compliance costs. Appropriate regulation should be based on three main principles. First, regulation should correct a market failure. Second, regulation must be effective. Even when a market failure is recognized, regulators should act only if there is a reasonable chance that they will actually address the failure in question. Third, the benefits of a particular regulation must be greater than the costs it imposes. In trying to solve one problem, regulators must avoid causing even greater problems.[14]

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[10] Luigi Zingales, "The Costs and Benefits of Financial Market Regulation", *European Corporate Governance Institute Working Paper Series in Law*, April 2004.

[11] Remarks by David Dodge, Governor of the Bank of Canada, to the Toronto CFA Society, Toronto, Ontario, 22 September 2005.

[12] Multilateral Instrument 52-11 Reporting on Internal Control over Financial Reporting and Companion Policy 52-111CP, Canadian Securities Administrators (except BC), 4 February 2005. The proposed Internal Control Instrument for TSX firms will impose requirements similar to SOX 404 and will be phased-in over four years based on the issuing firm's market capitalization.

[13] Canadian Securities Administrators Press Release, "Regulators Revise Timeline for Internal Control Reporting Project", 29 July 2005. The timeline has been extended by one year and the proposed instrument will now commence with financial years ending on or after 30 June 2007.

[14] Remarks by David Dodge, Governor of the Bank of Canada, to the Toronto CFA Society, Toronto, Ontario, 22 September 2005.

These principles are based on sound economic fundamentals. However, academics have argued that the second and third principles are often ignored by regulators.[15] One way to alleviate this problem would be to require regulatory agencies to carry out more thorough public evaluations of the costs and benefits of new rules.

Regulatory burden can be reduced by applying rules in a tiered way that takes into account the differing needs of issuers. For instance, one tier could apply to large, complex firms that want access to international capital markets. Rules for these firms would be similar to those that are applied in New York or London. At the other end of the spectrum, another tier could apply to small, speculative resource firms that have historically relied on Canadian equity markets for financing. A third tier in the middle could apply to the bulk of Canadian "mid-cap" firms, which choose to access only Canadian capital markets, and which very often are smaller and less complex than U.S. "mid-cap" firms.[16] This approach would prevent smaller, less complex firms from being burdened with complex rules that are more appropriate for larger firms.

It is important to note, however, that different tiers of firms exist in all major jurisdictions and investors in every jurisdiction have similar needs. Therefore, while the application of rules needs to take into account the size and complexity of firms (in order to take into account the cost-benefit trade off), there is no need for different rules to be applied based on the province or territory of the issuer or investor. Canada should have uniform securities laws and regulations based on principles that apply to everyone.[17] This will reduce regulatory burden for firms that operate in more than one Canadian jurisdiction by reducing costs that arise from duplication and inconsistent rules across jurisdictions.

3. Access to Capital

Canadian firms should have access to the capital they need, in markets where a full range of instruments is available to hedge risk. Capital markets play a key role in allocating capital and distributing risk. These markets need to operate efficiently in order to perform these functions effectively, allowing firms to have access to low-cost capital.

Research conducted at the Bank of Canada suggests that "Canadian capital markets appear to be relatively efficient for a country the size of Canada, but are less diverse than the larger U.S. capital market."[18] New asset classes have developed to address the needs of Canadian companies and investors. This research also indicates that "Canadian government securities markets react to macroeconomic news announcements in a manner similar to the highly liquid U.S. Treasury

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[15] Luigi Zingales, "The Costs and Benefits of Financial Market Regulation", *European Corporate Governance Institute Working Paper Series in Law*, April 2004. The author suggests the creation of a separate government agency dedicated to estimating the costs and benefits of any new securities regulation would mitigate this result. He proposes that the goal of this agency should be to "protect competition and new entrants."

[16] Remarks by David Dodge, Governor of the Bank of Canada, to the Toronto CFA Society, Toronto, Ontario, 22 September 2005.

[17] Remarks by David Dodge, Governor of the Bank of Canada, to the Toronto CFA Society, Toronto, Ontario, 22 September 2005.

[18] Scott Hendry and Michael King, "The Efficiency of Canadian Capital Markets: Some Bank of Canada Research", *Bank of Canada Review*, summer 2004.

market" suggesting that the quality of these markets "may be adequate."[19] However, Canadian capital markets are much smaller than those in the United States, Europe, and Japan. In order to remain efficient and competitive, we need to continue developing and enhancing access to new markets, instruments, and pools of capital.

It is also important to consider that Canadian capital markets do not exist in isolation, but form part of a global financial system. Canadian investors and firms are active in international markets, particularly the United States. For instance, Canadian firms issue about half of their corporate debt in U.S. markets to accommodate large issue sizes, to lower their cost of funds, or to hedge their U.S. dollar-denominated revenues and assets. As well, non-investment grade Canadian firms are choosing to raise funds in the U.S. high-yield market, which is the largest high-yield market in the world. The prominent use of U.S. financial markets by Canadian firms suggests that access to global sources of capital is important for Canadian companies.[20] As such, it is important to consider the role that Canadian securities regulation plays in a firm's decision to seek capital at home or abroad.

New technology can also play an important role in reducing transaction costs and thus enhancing liquidity and efficiency of capital markets. Electronic trading systems can support more efficient operations and information sharing, leading to faster trading, increased competition, and thus lower trading costs.[21] Although the evolution of electronic trading systems has tended to be slower in Canada than in the United States and Europe, progress has been made in the past couple of years with the recent introduction of new electronic trading systems, notably in fixed income markets. Securities regulation, if it is properly framed, can play an important role in advancing development in this area by not restricting innovation and competition.

Finally, the Task Force should be aware that there is a growing body of empirical evidence indicating that the effectiveness of a countries securities regulation has a systematic and important influence on its firms' cost of capital. For example, recent academic work shows that firms from countries that have more extensive disclosure rules and stronger enforcement, display significantly lower cost of equity capital, ranging between 30 and 700 basis points, depending on the quantitative technique used.[22]

4. Enforcement Issues

A good regulatory framework will not promote market efficiency without strong compliance procedures and effective enforcement.

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[19] Chris D'Souza and Charles Gaa, "The Effect of Economic News on Bond Market Liquidity", *Bank of Canada Working Paper 2004-16*.

[20] Scott Hendry and Michael King, "The Efficiency of Canadian Capital Markets: Some Bank of Canada Research", *Bank of Canada Review*, Summer 2004.

[21] Technological innovations could also, in principal, reduce the costs related to regulatory compliance.

[22] See for example Luzi Hail and Christian Leuz "International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?" *European Corporate Governance Institute Working Paper Series in Law No. 16/2003*, November 2003, and Utpal Bhattacharya and Hazem Daouk "The World Price of Insider Trading", *Journal of Finance*, Vol. 57(1), Feb 2002.

While U.S. securities agencies have pursued a number of high profile cases under insider trading laws that have generated large penalties and even jail terms, similar evidence of enforcement has been lacking in Canada. McNally and Smith (2003), for example, find large-scale evidence of insider trading and reporting violations, based on a study of stock buyback programs and insider trading around significant news announcements.[23] The Wise Persons' Committee to Review the Structure of Securities Regulation in Canada highlights that there is inconsistency in the enforcement powers and sanctions across provinces, with similar conduct resulting in widely varying sanctions depending on the jurisdiction in which it occurred and is prosecuted.[24] Bank of Canada research that finds Canadian firms have lower market valuations than similar firms listed in the U.S. links a perception of weak enforcement to the valuation of Canadian-listed firms.[25] Several researchers have suggested that a listing on a U.S. exchange by a non-U.S. firm increases its valuation because it subjects the firm to stricter SEC supervision and greater public scrutiny by U.S. investors and analysts.[26]

Effective enforcement requires that participants must be appropriately monitored, and offenders must be prosecuted and adequate penalties imposed when rules are broken. A regulatory framework with strong monitoring, prosecution, and application of penalties provides the incentives for firms to follow the rules. This, in the end, adds to the framework's credibility and enhances investor confidence in financial markets.[27] Thus, a coordinated approach by securities regulators and self-regulatory organizations, law enforcement agencies and other actors in the legal system to monitor, investigate, and punish improper behaviour is necessary at a provincial, national, and international level.

A study on Canadian enforcement by Puri (2005) finds that the current regulatory structure in Canada would benefit from greater co-ordination and co-operation in relation to enforcement policy-setting and priority-setting. Puri argues that a system should be devised to recognize sanctions imposed by one securities commission in other Canadian jurisdictions. The author also suggests that securities regulators should create, justify, and publicly disclose the factors that they take into account in deciding which enforcement actions to pursue.

Furthermore, the study recommends that Canadian securities regulators should continue to strengthen public enforcement efforts on the basis of the principle of deterrence. However, in addition to this they should also act as a facilitator to assist investors in receiving compensation for harms suffered in capital markets. That is, securities regulators should enhance investors' ability to privately enforce their contracts.

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[23] William McNally and Brian Smith, "Do Insiders Play by the Rules?", Canadian Public Policy, 2003.
[24] Wise Persons' Committee to review the structure of securities regulation in Canada, Department of Finance, 2003.
[25] Michael King and Dan Segal, "Valuation of Canadian- vs. U.S.-Listed Equity: Is There a Discount?", *Bank of Canada Working Paper 2003-06*.
[26] See John Coffee, "The Future as History: The Prospects for Global Convergence in Corporate Governance and Its Implications", *Northwestern University Law Review 93(3)*, 1999, and René Stulz, "Globalization, Corporate Finance, and the Cost of Capital", *Journal of Applied Corporate Finance 26*, 1999. For evidence that Canadian firms cross-listed in the U.S. are more highly valued than similar Canadian firms exclusively listed on the TSX see Michael King and Dan Segal, "International Cross-Listing and the Bonding Hypothesis", *Bank of Canada Working Paper 2004-17*.
[27] Remarks by David Dodge, Governor of the Bank of Canada, to the Toronto CFA Society, Toronto, Ontario, 22 September 2005.

This means that in addition to securities regulators, criminal law authorities including law enforcement agencies, crown prosecutors, and the judiciary have a key role to play in achieving effective enforcement. In the past, a lack of resources and expertise has been cited as the reason for few capital markets crimes being prosecuted by criminal authorities.[28] Recent steps taken by law enforcement agencies and the federal government to toughen enforcement are hence encouraging. One such initiative is the establishment of Integrated Market Enforcement Teams (IMET) by the federal government in 2002. These teams comprised of RCMP investigators, legal advisors, and forensic accountants, are involved in the "detection, investigation, and prevention of serious corporate and financial markets crime."[29]

Puri (2005) urges the Canadian judiciary to recognize the magnitude and impact of corporate crime on Canadians and the Canadian economy. The author highlights the need for judges to "better understand and apply economic theory in determining the appropriate sanctions for corporate offenders" in order to deter wrongdoing. The National Judicial Institute (NJI), which is "dedicated to the development and delivery of educational programs for all federal, provincial, and territorial judges", can play an important part in accomplishing this objective.[30] The Bank of Canada has been exploring opportunities to provide information to the judicial community in a balanced way through the National Judicial Institute about the role of the Bank and bank notes in the Canadian economy, and the harm, both economic and social, posed by counterfeit currency and financial market crimes.

The Bank of Canada is particularly concerned about the *perception* among market participants that Canadian enforcement of insider-trading laws is not as strong as it could be.[31] As Puri (2005) states, "*investor perceptions* about Canada's enforcement effectiveness relative to other jurisdictions, in particular the U.S., are important and need to be addressed, in light of the increased mobility of capital in today's global economy."[32] If we want to improve the effectiveness of our regulatory framework, it is imperative that we have, and be perceived to have, proper enforcement in Canada.[33]

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[28] Poonam Puri, "Enforcement Effectiveness in the Canadian Capital Markets", Capital Markets Institute, December 2005.
[29] http://www.rcmp-grc.gc.ca/fio/imets-faq_e.htm
[30] National Judicial Institute website - http://www.nji.ca
[31] Remarks by David Dodge, Governor of the Bank of Canada, to the Toronto CFA Society, Toronto, Ontario, 22 September 2005. See also the Insider Trading Task Force, "Illegal Insider Trading in Canada: Recommendations on Prevention, Detection and Deterrence", November 2003, which notes that there is a public perception that illegal insider trading is prevalent and increasing on Canadian markets and, although many suspected incidences of illegal insider trading are being identified through market surveillance, there have been few successful enforcement actions.
[32] Poonam Puri, "Enforcement Effectiveness in the Canadian Capital Markets", Capital Markets Institute, December 2005.
[33] Remarks by David Dodge, Governor of the Bank of Canada, to the Toronto CFA Society, Toronto, Ontario, 22 September 2005.