

Chapter 10

Analysis of Research Used in the Task Force's Deliberations

10.1 The Task Force determined that its work should be built around the answers to a number of areas of enquiry, which are outlined below. In attempting to understand these areas, future trends and issues we commissioned a number of academics and other experts to provide us with in-depth research – the researchers and a brief summary of the aims of their research are detailed below. In Schedule 10-A to this Chapter, we have also included a more detailed description of the research requested of each author.

Characteristics of Canada's Capital Markets

10.2 Before considering what steps might be taken to modernize and enhance the competitiveness of Canada's capital markets, it seemed important that the Task Force develop some understanding about what, if anything, is fundamentally different about the Canadian market when compared with those of its principal competitors.

Underlying Research

10.3 To this end research was commissioned by Professors Randal Morck and Bernard Yeung, whose study focuses principally on governance related characteristics of our market and those of the United States and the United Kingdom. Additionally, Professor Christopher Nicholls has provided a study outlining the unique attributes of Canada's capital markets. Professor Anita Anand's work explored the balance between issuers and investors in securities regulation in light of the characteristics of Canada's capital markets.

Understanding Changes in Competing Markets

10.4 If we are to modernize Canada's securities regulation, we need to understand what regulatory changes are occurring in the principal markets with which Canada competes. What are those changes and what motivates them? What do the positive or negative consequences appear to be – for the host market and for Canada, as a competing market? What steps have been taken in Canada itself in an effort to modernize?

Underlying Research

10.5 To answer these questions we have benefited from the input of Linklaters as to matters pertaining to changes to securities regulation in the United Kingdom and the European Union, Cleary Gottlieb Steen &

Hamilton LLP as to changes to securities regulation in the United States and Stikeman Elliott LLP as to changes to securities regulation in Canada, all as reflected in Chapter 3 and Appendix D.

The Attributes of a Competitive Capital Market

10.6 Before considering how one might enhance the competitiveness of Canada's capital markets one must understand those attributes of a capital market that enable it to be competitive. We have started from the supposition that for a capital market to be competitive it must find an effective balance between investor protection and ease of access for issuers.

10.7 Canada is sandwiched between a capital market which is historically tilted toward investor protection and thought by many to be over-regulated (the United States) and a market less regulated (in terms of prescriptive rules) than Canada (the United Kingdom).

10.8 As the United States strives to become a less "intimidating" market (without losing regulatory integrity), the United Kingdom – through the decision of the London Stock Exchange to outsource regulation of its Alternative Investment Market (AIM) to so-called "nominated advisers" or "Nomads" – has offered an inviting listing alternative. What are the implications of these significant shifts to the attractiveness of Canada's capital markets?

Underlying Research

10.9 Professor Adam Pritchard provided us with research regarding the "well known seasoned issuer" (WKSI) concept adopted in the United States as part of recent offering reform initiatives in that country. In short, the WKSI designation allows an issuer to access the capital markets in the United States with greater speed and efficiency through the use of "free writing" prospectuses and without review by the United States Securities and Exchange Commission. Professor Pritchard considered how the WKSI concept might be applied in Canada's capital markets.

10.10 Professor Stéphane Rousseau provided a study examining the extent to which AIM has been successful in attracting investors and issuers, particularly Canadian investors and issuers. The study also explores whether the Nomad concept and the outsourcing of regulation within a principles-based regulatory regime should and could be imported into Canada.

10.11 In an attempt to understand the attractiveness of the AIM market for issuers, Professors John Broad, Alfonso Dufour, Charles Sutcliffe and Stephen Wells provided a quantitative analysis of the effect on the share prices of companies cross-listed on AIM and the TSX.

10.12 More general studies of the attributes of competitive capital markets and the role of securities regulation in promoting them were prepared by Professors Eric Kirzner and Mark Gillen, respectively. As noted above, Professor Christopher Nicholls outlined the unique characteristics of Canada's capital markets as well as Canada's response to the sea change brought about by the *Sarbanes-Oxley* Act in the United States.

10.13 Professor Douglas Cumming provided an analysis of the competitiveness of Canada's capital markets by looking at whether Canadian companies are forced to "go public" too early due to a lack of adequate venture capital financing.

Rules vs. Principles

10.14 Much has been said, recently in the context of comparing accounting standards in Canada to those used elsewhere, about the differences between systems allegedly weighted toward principles or rules. Do rule based systems engender a box-ticking approach to compliance and provide a roadmap for evasion? If so, is this risk more than compensated for by the recognition that the regulated need the clarity of precise rules and that such a system will, for many, encourage voluntary compliance?

10.15 The same debate characterizes the analysis of competing designs for securities regulatory systems. If one is to make recommendations with regard to *modernizing* a securities regulatory system, clearly a determination should be made whether there is value to the "rules vs. principles" distinction. Should one aspect of modernization be to ensure that the system is tilted in the preferred direction?

10.16 Does the "rules vs. principles" distinction have merit? If so, which should be the principal driver of the system in Canada? Since enforcement is important to the credibility of a regulatory model, is a principles based, or a rules based system, more likely to be adhered to voluntarily, or to be enforced more effectively?

Underlying Research

10.17 Professor Lawrence Cunningham provided the Task Force with a study of the use of rules versus principles in securities law enforcement in Canada and the United States and its relative effectiveness.

The Role of Gatekeepers in Securities Regulation

10.18 The use of Nomads as "gatekeepers" by the London Stock Exchange raises the question of how regulation by mainstream regulators might be outsourced positively for the "system". As resources are stretched, could they be employed more effectively if certain aspects of regulation were outsourced beyond the self-regulatory organizations currently on the receiving end of outsourcing? Those who are already functioning unofficially as gatekeepers of the integrity of various aspects of the capital markets include: auditors, analysts, credit rating agencies, securities lawyers, underwriting investment bankers and "registered reps" who act as retail advisers. To the extent that some of these other gatekeepers are already in place and part of the regulatory net, is their role understood or misunderstood by the public, are they effective in their role and could their effectiveness be improved?

Underlying Research

10.19 The questions above regarding gatekeepers are considered in research provided by Professor Stephanie Ben-Ishai in a survey of the role of gatekeepers generally in the Canadian securities regulatory regime and, specifically with regard to investment analysts and their role as gatekeepers, by Professor Stephen Choi.

Regulatory Innovation

10.20 What steps might be considered to create an innovative approach to differentiate the Canadian capital markets from those of other jurisdictions?

Underlying Research

10.21 In this connection work has been undertaken by Professors Tom Baker and Harry Panjer to analyze the merits and challenges which would accompany a program to provide insurance coverage against damage from misleading information in the market. Professor Baker's work explores the possible design alternatives for such a program while Professor Panjer's study provides the actuarial analysis.

How Investors Make Investment Decisions

10.22 Since investor protection is a central objective of a securities regulator, it is essential to understand the process the investor (who is to be protected) follows in making an investment decision.

Underlying Research

10.23 Professor Richard Deaves along with Catherine Dine and William Horton provided the Task Force with a report outlining the literature surrounding investor decision-making as well as a survey of Canadian investors to determine how they make their investment decisions.

Educating Investors

10.24 Disclosure has been the principal "holy grail" of regulatory initiatives in Canada for many years, including of course the continuous disclosure system and establishing civil liability for missing the disclosure mark. However, disclosure of information and providing information in a way which encourages "the horse to drink" are different matters. The Task Force felt strongly that much could be done in this regard. How could we do a better job to educate, and to inform, rather than merely to disclose?

Underlying Research

10.25 Extensive work has been provided in an effort to address these critical questions. To begin with, Caroline Cakebread has analyzed the aggregate efforts of public sector educators in Canada and examined comparable efforts in the United Kingdom and the United States. Professor Julia Black has provided research examining how securities regulators in Canada and the United Kingdom currently involve investors and determine their interests in designing securities regulation.

The Need for Disclosure

10.26 Rather than attacking the effectiveness of what disclosure is currently mandated, there are those who question its need and would strongly advocate releasing the disclosure noose around the neck of corporate Canada. Those advocates might well contend that the market is self-policing – the "buy-side" being quite capable of shunning corporations which are not providing adequate and reliable disclosure to potential

investors. Corporations that are seeking capital, or having sought capital, wish to maintain the value of their “currency”, will ensure that the market's appetite for information is sated. Further, to whatever extent such regulation is in fact necessary, the validity of the “regulatory overkill” argument shifts to a consideration of whether two-tiered or staged regulation with regard to disclosure should be adopted (to a greater extent than presently) in order to respond to the cost-benefit issues for junior (for lack of a better term for the moment) issuers.

Underlying Research

10.27 These issues have been addressed in research provided by Professors Christian Leuz and Peter Wysocki.

10.28 The regulatory “overkill” issue has been explored in two ways. First, the utility of a cost benefit analysis as a precondition to a new regulation was specifically addressed in a research paper prepared by Larry Schwartz. Second, there arises the evident consequence, playing out on the international and national stages currently, that issuers who are public are going private, issuers who are private are staying private longer and issuers who are public in a heavily regulated jurisdiction are considering shifting the site of their listing to a less imposing venue. The research of Leuz and Wysocki has also addressed these issues.

Effective Disclosure

10.29 Apart from the delivery system (see below) how can information which is requisite disclosure be packaged and presented in a less intimidating way?

Underlying Research

10.30 Professor Janis Sarra completed a study of the effectiveness of disclosure in the Canadian regulatory system. As noted above, Professor Richard Deaves et al. provided the Task Force with research regarding how investors make investment decisions, which in part addressed the issue of how disclosure can be presented in a more effective manner. Relatedly, Professor Dimity Kingsford Smith's work provided some useful insights regarding how information can be presented in a more effective manner using modern technology.

Effective Disclosure – Delivery using Technology

10.31 The Task Force was intrigued by the glaring discrepancy between, on the one hand, the ability of those who want to attract a potential investor to information about their product or service to do so effectively by the use of imaginative e-delivery, and, on the other, the ability of corporate disclosure documents to set a new standard for impenetrability and lack of reader appeal. There has to be a better way.

Underlying Research

10.32 In this context, the Task Force commissioned the technical expertise of Navantis Inc. and Dean Pelozzo of DisclosurePlus to design a new model of e-disclosure that would attract readers and allow them to dig into the disclosure they are reviewing.

Enforcement

10.33 Finally, the issue which all who approached us had on centre stage was the perception of inadequate enforcement of Canada's securities laws and that what enforcement that has been undertaken is often flawed, whether at the investigative, prosecutorial or adjudicative stages. This left us with several questions:

- Is the perception warranted?
- If so, why and how could the shortcomings best be explained and addressed?
- What is the cost to Canada's capital markets of poor enforcement?
- Is enforcement less financed or understaffed in Canada compared with the United States, or must one look for other explanations?
- Are there procedural or other systemic flaws in the enforcement process? If not, of course it would be equally important to inform the market of the successes and the balance achieved by Canadian regulators – recognizing that many do not find the litigious US model a model which Canada should emulate.
- Since enforcement has of necessity a negative after the fact aspect – the damage from compliance violation already having occurred, an important aspect of an overall enforcement structure is how best to encourage voluntary compliance and minimize the need for ex post enforcement activities. What effort is directed at achieving this important goal?

10.34 We were anxious to address these critical questions both from the basis of a sound academic analysis of the "reality" at work, and also from the very practical standpoint of the senior judge and litigator.

Underlying Research

10.35 To that end several research papers were commissioned. Professor Utpal Bhattacharya looked at the impact of securities law enforcement on the cost of capital. Professor Howell Jackson studied the budgets and staffing levels for securities regulators in the United States and Canada and then compared the "intensity" of securities law enforcement between the two countries. As noted above, Professor Lawrence Cunningham studied the relevance of rules versus principles in securities law enforcement in Canada and the United States and their relative effectiveness.

10.36 Professors Mary Condon and Poonam Puri authored a report that considered the strengths and limits of a compliance-based approach to the regulation of the Canadian capital markets. Their study analyzed the viability of compliance-based tools and strategies within the wider securities enforcement framework.

10.37 The Honourable Peter Cory and Professor Marilyn Pilkington were commissioned to provide the Task Force with a report identifying the critical issues in the enforcement of securities laws in Canada. They have examined issues relating to the investigative process, jurisdiction, prosecution and adjudication of securities law offences and penalties.

The Regulatory Response to “New” Investment Products

10.38 To *modernize* securities laws must surely involve the ability of the regulatory net to encompass, where necessary, modern products, and conversely, where appropriate, to allow the novel to function unregulated should there be no need to regulate.

10.39 High in profile in recent months have been hedge funds. Should retail investors be permitted access to the risk-reward profile of such instruments? If so, is the regulation of those who develop and manage such products in the interests of capital markets, or would it risk chasing a valuable talent pool elsewhere?

Underlying Research

10.40 The implications of hedge funds for Canada and for regulation have been addressed by André Fok Kam and a background paper regarding recently exposed problems with two Canadian hedge funds has been prepared by G. Wesley Voorheis.

