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Chapter 9

An Idea for Consideration: Insurance against "Misinformation" in Canada's Capital Markets

9.1 In earlier chapters we discussed the importance for all Canadians of maintaining the vitality of Canada's capital markets. We have identified the "Canada discount" – the discount applied to securities traded in Canada due, in part, to the real or perceived laxity in Canada's securities regulation, particularly in the area of enforcement.

9.2 We have also shown that securities regulation is fluid and ever-changing as regulators jockey to create frameworks that will not only protect investors but also help to give their home market a competitive advantage. The creation of the Alternative Investment Market and the Nominated Adviser (NOMAD) concept in the United Kingdom is one example of this, as is the introduction of the "well known seasoned issuer" concept in the United States. These markets have attempted to distinguish themselves through regulatory innovation. Canada needs to do the same.

9.3 Throughout this Report we have made various recommendations to modernize securities legislation in Canada that we believe will, at the same time, maintain or enhance the competitiveness of Canada's capital markets and continue to protect individual investors. We regard each of these recommendations as important and, it goes without saying, we heartily encourage their implementation or in some cases further study. At the same time, however, we acknowledge that our recommendations are evolutionary, rather than revolutionary, in nature. We have no qualms in pointing this out. Modernization is, after all, an evolutionary process that entails building on what is already in place and attempting to make it better.

9.4 Nonetheless, the Task Force has wondered whether the time has come for the introduction of a bold, innovative step – a revolutionary step, perhaps – as a means of distinguishing Canada's capital markets. We have devoted some time to exploring such a step – insurance against misinformation in the capital markets – and have commissioned two research papers by industry experts to inform us and to inform whatever policy review that may be generated by what follows.

9.5 Our idea of insurance against capital market risk is hardly new. What *is* new is the specific category of risk which we propose be targeted. While our idea is still in its nascency and is not one which we feel ready to either recommend or discard, we believe it is an idea which merits careful study.

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A Question of Risk

9.6 Virtually every aspect of capital market behaviour carries risk, and the degree of risk taken is ideally commensurate with the rewards anticipated by the investor. Risks can of course be categorized – with acknowledged frailty and with some overlap – into "market risk", "investment merit risk" and "behavioural risk". Market risk can be characterized as the risk associated with the natural ebb and flow of the market and the difficulty of timing entry and exit without the proverbial "crystal ball". Investment merit risk is, quite simply, the risk of choosing the wrong stock, and behavioural risk is the risk of ineptitude or malfeasance by an issuer's management and directors.

9.7 The linkage among these three categories of risk will be obvious: behavioural risk affects the extent to which the potential of an issuer is achieved; as a result investment merit is a function of the "hard asset" potential of the issuer and the behavioural reliability and integrity of those in charge.

9.8 Market risk depends clearly on a multitude of macro level issues – both domestic and international. The connection between this and the other two categories is two-fold. First, aberrant behaviour affects the issuer where that behaviour is at work and, more importantly from a systemic perspective, can have implications for the reputation of the capital markets generally. A glaring Canadian example is the "closed for business" sign which the Bre-X Minerals Ltd. fraud placed on the capital raising ability of much of the Canadian mining industry for a lengthy period.

9.9 In Canada certain capital market risks are addressed in several ways through securities regulation:

- *Behavioural risk* – investors are at least partially protected by securities laws and their enforcement. That enforcement comes through public sector enforcement and private sector litigation enforcement.
- *Investment merit risk* – investors are protected by disclosure laws that mandate the accurate and timely disclosure of all material information regarding an issuer, the violation of which leads to enforcement action.

9.10 With regard to market risk investors can protect themselves to some degree by diversification but with regard to issuer specific risk, and the risk of systemic reputational concerns which results from extreme examples of behavioural risk, issuers and investors alike, as well as the market generally, are largely unprotected. Further, with respect to behavioural risk, when it comes to inadequate, inaccurate or untimely disclosure to capital markets, the fact that securities law has been broken and that a penalty has been exacted after what are often protracted enforcement proceedings, is "cold comfort" to an injured investor. Their remedy is to initiate or join in a civil action (which is at least easier than prior to January 1, 2006).

9.11 Regulators have, in the face of mounting public expectation that it is part of a regulator's job to help get the aggrieved investor's money back, been seeking the power to order compensation by the wrongdoer.[1] The ability of investors to seek relief indirectly in this manner is still in its infancy. Whether recovery is sought through a civil action or through the regulatory route, there can be no assurance that the defendant will be "available" or that he will not be judgment proof.

The Role of Insurance

9.12 There is another approach which deserves consideration. Historically, investors have been insulated against various capital market risks also by insurance, which may be designed and provided by either the private sector or public sector. Several examples readily come to mind (and there are undoubtedly other examples):

- Bank deposits are insured in Canada up to $100,000 (principal and interest) against bank failure through the Canada Deposit Insurance Corporation, a federal Crown Corporation. The policy rationale for such a program hardly needs much elaboration. In essence the unquestioned safety of the average person's bank account is considered a national imperative.
- Similarly, the brokerage community has established and maintains the reputational safety of funds lodged with a member of the Investment Dealers Association of Canada through the Canadian Investor Protection Fund (CIPF). Whether the failure of the brokerage firm results from inept or dishonest management or the materialization of market risks sensibly taken by the firm, CIPF stands behind the safety of the deposited client funds.
- The disappearance of pension benefits in the event of the bankruptcy of a corporation resulting in the inability of the pension plan to pay a promised benefit is protected against by the Pension Benefits Guarantee Fund (PBGF) in Ontario.
- The disappearance of insurance benefits due to the insolvency of a federally regulated insurance company is protected against by the Property and Casualty Insurance Compensation Corporation (PACICC) and Assuris, a not-for-profit organization established by life insurance companies operating in Canada.
- With respect to behavioural risk, the ability of a successful plaintiff to recover damages *may* be indirectly assisted, to some extent, through directors' and officers' (D&O) insurance. The availability of such insurance is uncertain since there is no regulatory requirement that it be obtained by a public company and since such policies do not cover fraud. Even if the insurance exists, the ability of injured parties under some circumstances to access that insurance is problematic.

[1]Under paragraph 127(1)(10) of the *Securities Act* (Ontario), the Ontario Securities Commission has the power to issue an order requiring a "person or company to disgorge to the Commission any amounts obtained as a result of non-compliance" with Ontario securities law. Where the disgorged monies end up is determined by subsection 3.4(2) of the Securities Act, which states: "The Commission will pay into the Consolidated Revenue Fund [of the Ontario government generally] money received by the Commission pursuant to an order under paragraph 9 or 10 of subsection 127(1) of this Act…or as a payment to settle enforcement proceedings commenced by the Commission, other than money, (a) to reimburse the Commission for costs incurred by it; or (b) that is designated under the terms of the order or settlement **for allocation to or for the benefit of third parties**." [Emphasis added.]

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9.13 Of course, the parallels between the above-cited examples and the situation of an investor harmed by misleading or inaccurate disclosure are in some respects wanting. Canadian banks incorporated under the *Bank Act* and federally-incorporated insurance companies are supervised by a regulatory agency known as the Office of the Superintendent of Financial Institutions which regularly examines the operations and finances of these institutions in order to avoid the loss of deposits or claims-paying ability. Provincial deposit-taking institutions and insurers have similar supervision. But no one oversees the preparation of financial records, disclosure filings, press releases etc. of a reporting issuer. Regulation is limited to an obligation to disclose fully and truthfully, but no authority could foresee or prevent misinformation in the public domain and, thus, protect against or diminish the potential losses occasioned by it.

9.14 Nevertheless, glaringly absent from the capital market risks which are mitigated by insurance directly are the very risks which, when they materialize, capture the greatest notoriety and incense the public – namely, the risks associated with *misinformation* in the marketplace. The term "misinformation" is without meaning in Canadian securities law. We use it to include both misrepresentation (i.e., an untrue statement or the omission of a fact necessary to make a statement not misleading) and informational delay.

9.15 When misinformation occurs at a high profile level (notable examples in everyone's mind being Bre-X Minerals Ltd. in Canada or Enron Corporation, WorldCom Inc. and others in the United States) the entire market is affected, not merely the market in the subject stock.

9.16 As has been elaborated elsewhere in this report, Canadian securities have historically been subject to a "Canada discount". This discount is attributable to a number of factors – but certainly those factors would include the "wild west" reputation borne for years by the Vancouver Stock Exchange (whether or not justified), the perception (whether or not justified) of inadequate enforcement of securities laws and the practical impossibility of any meaningful route to recovery through civil action.

9.17 The first of these factors has been carefully addressed by careful clean up activities in Vancouver, both by regulators and by member firms, by the merger of the Vancouver and Alberta stock exchanges and the subsequent re-branding as the TSXV coupled with careful regulation. The second of these factors, whether reality or perception, is addressed in Chapter 7 of this report, as well as in the research papers of Justice Peter Cory and Professor Marilyn Pilkington,[2] and Professors Puri and Condon,[3] which were commissioned by the Task Force. Finally, the last of these factors has recently been addressed to some extent by statutory civil liability provisions in the securities laws of Ontario, Alberta and Manitoba, and under consideration in other provinces of Canada.

9.18 Nonetheless, the "Canada discount" does still exist. One statistic provided by the Bank of Canada which should stand out in the mind of anyone who questions the importance of the "Canada discount" is that every 50 basis point decline in the corporate risk premium associated with Canadian issuers translates into an approximate increase in gross domestic product in the range of 0.8 to 1.0%.[4] This issue affects not only issuers

[2]See The Hon. P. Cory & M. Pilkington, "Critical Issues in Enforcement" in Volume VI.

[3]See M. Condon and P. Puri, "The Role of Compliance in Securities Regulatory Enforcement" in Volume VI.

[4]Bank of Canada, "Implications on the Canadian Economy of a Fall in the Corporate Risk Premium" (January 2006) (unpublished research note).

and direct investors, but every pensioner and pensioner in waiting who wants their portfolio of Canadian securities to be valued with as little national risk premium as possible.

9.19 Can something revolutionary be done? One idea is to establish a framework which would allow issuers in Canada to say to investors: "subject to the limits of our program if you chose to participate in Canada's equity markets, you will not lose your money because of misinformation in the market place. You may pick the wrong stock (investment merit risk), the market may move against you (market risk), but if the market is misled, we will stand behind the integrity of our markets and we will insulate you from that risk".

9.20 With the potential appeal of such a program in mind, and with an equally clear view of the possible negatives – and difficulties of implementation – two studies were commissioned by the Task Force. Professor Tom Baker[5] looked at the potential design of such a program while Professor Harry Panjer[6] looked at the actuarial aspects. What follows is an overview of their findings.

9.21 We recommend that readers of this Report take the time to read the reports of Baker and Panjer thoroughly. They each contain detailed analyses of how such an insurance program might be designed. Some, but not all, of their observations are referred to below.

9.22 We suggest that the place to start is *not* with a discussion of how such a program might be created, nor even with a discussion of essential design details (Who can make a claim? Against whom can a claim be made and for what damage? How would the program be funded?) Rather the place to start is at the end by asking two questions: (i) would such a program be net beneficial to investors and (ii) could such a program be beneficial in enhancing the competitiveness of Canada's capital markets?

9.23 The opinion of Professor Baker regarding these two questions is summarized in the Executive Summary to his report:[7]

> The most powerful objection to this new concept is that investors do not need a new insurance program for securities misinformation losses. Individual and institutional investors already can spread securities misinformation losses by holding a diversified portfolio. Investors already are entitled to receive compensation for these losses through securities litigation, most significantly under the new Ontario secondary market liability legislation… Moreover, Canadian public companies already have insurance that spreads these liability losses: Directors' and Officers' Insurance.
>
> Nevertheless, a securities misinformation insurance program has the potential to provide the following systemic benefits to the Canadian capital markets:
>
> - Improved compliance with securities laws (resulting from cost internalization by issuers and governance efforts by the securities misinformation insurance program); and
> - Enhanced investor confidence (resulting from the signalling effect of what amounts to a warranty of compliance with disclosure requirements).

[5]See T. Baker, "Insurance Against Misinformation in the Securities Market" in Volume II.
[6]See H. Panjer, "Insurance Against Misinformation in the Securities Market: Actuarial Aspects" in Volume II.
[7]See Baker, *supra* note 5 at 370.

9.24 These views clearly deserve careful consideration.

- While investors can mitigate misinformation risk by diversifying their portfolio, investor behaviour frequently diverts from the rational. As we saw in Chapter 4 and in the research paper by Professor Deaves et al.,[8] the typical investor is limited by a short attention span, inattention to detail, dependence on potentially suboptimal heuristics, overconfidence, biases and emotion, to name a few. We do not recall investors who lost money on Bre-X or other prominent Canadian examples of misinformation feeling better about their loss due to diversification. If so, these views were ill publicized.
- The fact that an injured motorist can claim against the driver at fault does not render motor vehicle insurance unnecessary or imprudent. Similarly the fact that an investor now has an improved cause of action against those responsible for misinformation does not, surely, render an insurance program with respect to such an injury unnecessary.
- The existence of D&O insurance, cancellable by the company in question, cancellable by the policy issuer, and at its best not mandated by securities law can offer only limited comfort to injured investors. Particularly must this comfort be limited when most D&O policies have an exclusion for fraud – just where the investor needs protection.

9.25 What is intriguing is Professor Baker's comments with respect to the fact that an insurance program has the *potential* to offer systemic benefits for Canada's capital markets – this potential deserves our careful consideration. Professor Baker says that realization of such benefits "...would depend in significant part on the design of the program." He offers a number of structural alternatives and suggestions, which we will explore below.

9.26 What does Professor Panjer – who approached the idea from the point of view of an actuary – say on the subject? In his observations and conclusions, Professor Panjer[9] states:

> Misinformation risk is faced by all investors, both individual investors and institutional investors such as pension plans. The loss occurs when securities are bought (sold) at prices that are too high (low). Thus, misinformation causes a temporary aberration in the price of a security. Therefore, misinformation that is corrected is likely to have little long-term impact on markets. However, the cost of a misinformation event to a single investor can be large. **The idea of an investor protection program is to protect those investors in order to develop greater confidence in the securities market. This greater confidence in an insured Canadian market enhances the competitiveness by differentiating Canadian markets from uninsured markets.** [Emphasis added.]

9.27 In discussing whether such a program should be government run, Professor Panjer[10] states:

> …it may be argued that government's supporting the enhanced competitiveness of Canadian markets is in the national interest by making Canada a more attractive place to place capital, resulting in greater investment in Canada, resulting in more jobs for Canadians, etc.

[8]See Deaves, Dine & Horton, "How are Investment Decisions Made?" in Volume II.
[9]See Panjer, *supra* note 6 at 457.
[10]*Ibid*.

9.28 Before reading further, readers are invited to remember that the "driver" behind a program of insurance against misrepresentation is to differentiate Canada's capital market in a positive way (offering a safety blanket to investors offered in no other capital market to our knowledge) thereby enhancing liquidity and reducing the "made in Canada discount".

9.29 Against that backdrop a series of questions should be considered:

Philosophical

- Would the existence of such a program carry the implied negative that Canada had to provide insurance to compensate for the substandard disclosure in its markets? Professor Baker points out that the issue of the positive or negative implication of a warranty had been well considered and the public's conclusion is that a warranty is a testimony to a manufacturer's confidence in their product rather than a response to consumers' lack of confidence.[11]

Substantive

- How would such a program be designed – who would be entitled to make a claim? How would damages be measured? How would a claim be made? How would such a program be funded? Who would administer it? Each of these questions has been addressed in the research papers and Professor Baker has set forth three alternative designs, pointing out that features that he has for convenience allocated to one alternative could just as well have populated another design.

9.30 Professor Baker presents the following three design alternatives:[12]

(1) Establish a new Crown corporation, the Canadian Investor Insurance Corporation (CIIC), modeled after the Canada Deposit Insurance Corporation to provide insurance against misinformation in the capital markets. The CIIC benefits would be primary, meaning that investors would be able to collect benefits from the CIIC without first having to bring a private action against the purveyors of misinformation.

(2) The stock exchanges in Canada would mandate that issuers whose securities trade on their exchanges must participate in a new insurance program which could be called the Canadian Securities Fraud Protection Fund. This program would be excess to civil liability, meaning that aggrieved investors would first have to succeed in a private civil action against the parties responsible for the misinformation and attempt to recover on the judgment.

(3) Legislation would be enacted that requires issuers to obtain misinformation insurance from a licensed insurance company or to disclose the decision not to purchase such insurance. This insurance would be excess first party liability insurance and would function, to use the language of the insurance industry, as if it were a "difference in condition" policy that is excess to the liability insurance policies of all

[11]See Baker, *supra* note 5 at 391 where he states: "A…potential benefit of securities misinformation insurance comes from the signaling function that insurance, similar to the signaling function that economists attribute to generous product warranties. In the economics literature, consumers are understood to pay attention to warranties, not primarily because they intend to go through the complicated procedures needed to obtain the warranty benefit, but rather because the warranties signal the high quality of the product."

[12]See *Ibid*. at 404-407.

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potential defendants to a civil action relating to an issuer that purchased the insurance. The misinformation insurance would become available in the event that any of this liability insurance is uncollectible for any reason or if it is exhausted.

9.31 It may be easiest for readers if we first focus on what we regard as common attributes of any such structures. Policy makers might consider the merits of an insurance program built closely around the secondary market civil liability regime already in place in Alberta, Manitoba and Ontario (for ease of reference, the "civil liability regime"). Specifically:

- Subject to one critical qualification stated below, any party having a claim under the civil liability regime would be an insured investor.
- The amount of the claim would be subject to exactly the same limits as apply under the civil liability regime (i.e., the greater of 5 per cent of the issuer's market capitalization and $1 million).
- Multiple misrepresentations would, as under the civil liability regime, be treated as one, for claim limit purposes.

The exception is that only investors who traded a stock through the facilities of a Canadian stock exchange would be entitled to the benefit of the program.

9.32 Starting with these common features, a program of insurance can be designed in three ways, as Professor Baker has pointed out. We were not inclined to devote time to the private sector alternative, since the insurance industry has had the opportunity to address this market gap and, so far, has not chosen to do so.

9.33 That leaves two alternatives. Either the program should be structured through a stock exchange (which desired to distinguish itself and its product) or should be created by government, in recognition of the national importance of a sound and credible capital market. Each route has merit. We have reached no conclusion as to whether one is preferable to the other.

9.34 A key consideration (which would apply whether the program is stock exchange driven or government established) is the source of funding. Logical sources are investors and issuers:

(1) Investors' interests are served by such a program not only for the obvious reason but also because the value of the equity they hold should be more fairly priced as the Canada discount is reduced. Funding from them could be provided by a per trade fee which would be a function of the dollar value of the trade in question.

(2) Issuers' interests are served by such a program by virtue of the anticipated reduction in the cost of capital (as the Canada discount is eroded) and by the enhanced liquidity which could result from the increased willingness of investors to trade in Canada.

9.35 Each alternative funding mechanism itself raises issues. First, with regard to a per trade fee, there is a risk that making trading more expensive in Canada (by however slight a margin) might encourage volume traders to trade elsewhere in the case of an inter-listed security. And there is the concomitant risk that such a tendency would make listing in Canada less attractive to Canadian issuers – careful study would have to be completed to ensure that such a cost would not have negative implications for Canada's capital markets.

9.36 However the opposite is easily arguable: if an inter-listed security experienced a fraud and an institutional investor chose to trade outside Canada, thereby forfeiting access to the insurance, how could that decision be justified "after the fact"? How would a registered adviser explain to their client that the trade had been made outside Canada when execution in Canada would have carried, for a fee, greater protection?

9.37 With regard to the prospect that funding might be provided by issuers, whether by an annual listing fee or by a government insurer (just as CDIC is funded by a levy against deposit-taking institutions), such a system would itself raise the question whether the fee should include a rating system, or simply be a fee based on market capitalization, unrated.

9.38 There are clear policy attractions to a system which embraces a rating concept (including the obvious corporate search for excellence which rating based premiums would induce). However our inclination is that due to the multiplicity of reporting issuers, such a system would be impractical and that a simple market cap fee would have appeal. Professor Panjer considers this and points out that although the "good" disclosure companies would be to some extent subsidizing the "bad", all companies – even the exemplary ones – would benefit from the market reputational enhancement which the program would create.[13]

9.39 Lest our analysis lead the reader to conclude that we have been one-sided or blind to some of the very real issues this concept raises, we enumerate here a number of very serious considerations which would make this idea somewhat less attractive:

- The moral hazard of an analogous government-initiated program led to the financially-disastrous decision by the Government of Canada to refund all of the deposits in the Canadian Commercial Bank and Northland Bank failures (after a Commission of Inquiry led by former Supreme Court of Canada Justice Willard Z. Estey) because actions of and statements by the Bank of Canada had led depositors to believe their deposits were safe. In easily imaginable fact patterns, the same could happen in relation to misinformation claims against an issuer.
- The present limits for secondary market civil liability recovery in the legislation of those provinces providing for it are small (in relation to the market capitalization of issuers). They would clearly not accomplish anything where the whole company went bankrupt in terms of real protection and could set off a clamour to increase the limits imposed on a program of insurance against misinformation.

[13]See Panjer, *supra* note 6 at 442.

- Despite the limits suggested, the costs of a program for insurance against misinformation would not be illusory and would, in and of themselves, add to the cost of capital before there was any evidence that the increased sense of security engendered by insurance actually diminished the so-called "Canada discount".
- The carelessness of investors in protecting themselves by knowledge, careful examination of the facts and diversification might well be enhanced, instead of diminished.

9.40 In conclusion:

(1) We encourage policy makers to take the time to read the excellent research papers of Professors Baker and Panjer. Each paper contains detailed analyses of issues which have been raised summarily above.

(2) We are not in a position to recommend, nor to discard, this insurance proposal. We recognize that there is much to be thought through before one could reach a conclusion either way, but we do recommend that policy time be spent giving it careful analysis. Properly designed, it could be a constructive way to distinguish Canada's capital markets from the competition.