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Research Study

Insurance Against Misinformation in the Securities Market

Tom Baker

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Evolving Investor Protection

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Tom is the author of *Insurance Law and Policy: Cases, Materials and Problems* (Aspen 2003) and many articles and book chapters relating to insurance, risk, and responsibility. He is a contributing editor of *Embracing Risk: The Changing Culture of Insurance and Responsibility* (U. Chicago P. 2002) (with Jonathan Simon), which helped to establish the emerging sociology of risk and insurance. His most recent book, *The Medical Malpractice Myth* (U. Chicago P. 2005), examines the misperceptions behind the tort reform movement and proposes an evidence-based approach to medical liability reform. His primary current research project examines the relationship between directors' and officers' liability insurance and corporate governance and the role of insurance in securities-related litigation.

Professor Baker has also taught insurance and related courses at the University of Miami School of Law, Yale Law School, and the Hebrew University of Jerusalem (where he is a frequent visitor). A member of the Scientific Committee of the Geneva Association for Risk and Insurance Studies, he regularly lectures on insurance in both academic and professional settings. He is the founder and facilitator of the New England Insurance and Society Study Group, an interdisciplinary group of scholars engaged in insurance-related research. In addition, he is regularly consulted in connection with insurance-related litigation, regulation, and transactions.

Before entering law teaching, Professor Baker clerked for Hon. Juan R. Torruella (1st Cir.), practiced with the firm of Covington & Burling in Washington, D.C., and served as Associate Counsel in the Office of Independent Counsel (Walsh) investigating the Iran-Contra affair. He received his B.A. and J.D. from Harvard University, *magna cum laude*.

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1. **Executive Summary**

This report prepares the Task Force to evaluate a new capital markets insurance concept: securities misinformation insurance. Designed to enhance the competitiveness of Canadian securities market, this new insurance would compensate investors for losses caused by Canadian securities law violations.

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 described in Section 4, ii. 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).[*]

Whether a new insurance program would in fact produce these benefits would depend in significant part on the design of the program. On the one hand, the program could be designed as a form of *excess insurance* that would pay investors only after they exhausted the available assets of the responsible parties. In that event, the insurance program would, in effect, guarantee the solvency of the responsible parties (up to the limits of the benefits provided by the program). On the other hand, the program could be designed as *primary insurance* that would pay investors

[*] In addition, it is argued that merit-based investors may not be diversified and thus would benefit from the loss spreading provided by an insurance program. This latter benefit would be unlikely to justify imposing the insurance loading costs on all investors for reasons that are explained in the report.

without requiring that they first bring a private party civil liability action. In that event, the investors would assign to the insurance program their rights against the responsible parties, and the insurance program could then bring civil liability actions against those parties.

The *excess* insurance approach would be cheaper and less intrusive for Canadian public companies, but it would be unlikely to enhance securities law compliance. The *primary* insurance approach would be more likely to enhance securities law compliance and, possibly, investor confidence, but it would be more expensive and intrusive. Under the latter, primary insurance approach, the securities misinformation insurance program could become a strong securities market regulator. The "regulation" would come in the form of underwriting requirements and other requirements imposed through litigation against the responsible parties. Whether a new, strong, and potentially unaccountable securities regulator would be desirable is a question for the Task Force to consider.

This report describes these and other important insurance design questions. To illustrate how the design variables fit together, the report outlines three different securities misinformation insurance scenarios. The first scenario presents a government sponsored, primary insurance program. The second scenario presents an industry sponsored excess insurance program. The third scenario presents a private market excess insurance approach. The author of this report is an insurance expert, not a securities or corporate law expert. The goal is to educate the Task Force about the insurance issues so that they can weigh the potential costs and benefits of a new securities misinformation insurance program.

2. Recommendations

Recommendation #1: Evaluate the design options and determine the most favourable form for a Securities Misinformation Insurance program.

Recommendation #2: Gauge the appeal of such a program to stakeholders.

Recommendation #3: If the program is sufficiently appealing, retain an actuarial firm with experience pricing D&O insurance to specify the pricing and funding needed to support the program, as outlined in the companion report of Professor Harry Panjer.

3. **Introduction**

Insurance institutions protect individuals from a variety of risks in the Canadian capital markets. These include the risks of:

- Bank deposits disappearing in the event of a bank failure (CDIC);
- Investments disappearing due to investment dealer failure (CIPF, CIPC);
- Pension benefits disappearing in the event of a bankruptcy of a corporation and the inability of the pension plan to pay promised benefits (PBGF); and
- Insurance benefits disappearing due to insolvency of an insurance company (Assuris, PACICC).

There is no direct insurance against loss of investment value due to misinformation in the securities market. At present this risk is addressed through:

- Diversification by investors;
- Litigation on behalf of investors damaged by misinformation; and
- Enforcement by government agencies and self-regulatory organizations.

Some misinformation risk is insured indirectly through liability insurance that covers defendants in securities-related litigation (principally directors and officers liability insurance but also professional liability insurance). What would a program of direct insurance against investment losses from securities misinformation look like? Could it be designed so that the benefits exceed the costs?

This report addresses these questions. Section four describes the existing securities misinformation deterrence and loss spreading institutions that any new insurance program would supplement or replace. As this discussion notes, investors already can spread Canadian securities misinformation losses at low cost by holding a diversified portfolio of Canadian securities. Moreover, private market civil liability already provides a way for investors to receive some compensation for their misinformation losses. For these reasons, investor compensation does not provide as strong a justification for a new securities misinformation insurance program as it does for the existing forms of capital market insurance.

Section 5 begins by introducing a set of theoretical issues that inform the design of insurance institutions generally and discusses those issues in the context of securities misinformation insurance. This discussion sharpens the analysis of the existing diversification and loss-spreading possibilities and argues that a new securities misinformation insurance program may be able to be justified on the basis of systematic benefits: improved securities law compliance and increased investor confidence in the transparency of the Canadian securities market. Section 6 then describes the main variables that should be considered in the design of a securities misinformation insurance program. Section 7 outlines three scenarios that illustrate these variables in combination. Section 8 concludes by summarizing the report in the form of a conceptual cost benefit analysis.

This report raises theoretical and conceptual issues. It does not provide answers. The goal is to explicate the design variables and tradeoffs in order to allow members of the Task Force to reach their own conclusions about the potential costs and benefits of a new securities misinformation insurance program and the form, if any, that it should take. Evaluating those costs and benefits requires making predictions about the behaviour of the Canadian securities markets (and current and potential investors in those markets) in response to a securities misinformation insurance program. Such predictions are the province of experts and professionals with more knowledge about securities markets, investor behaviour, and securities misinformation losses.

4. Securities Misinformation Loss: Existing Deterrence and Loss-Spreading Institutions

Securities misinformation insurance is insurance that compensates investors for a "securities misinformation loss." In this report, "securities misinformation loss" will mean legally compensable investment loss from inadequate or untimely disclosure as defined by Canadian securities law. A securities misinformation loss occurs when, for example, an investor buys a security at a price that is inflated because the issuer withheld bad news from the market and then holds that security until the bad news is revealed and the value of the security declines as a result.

Canadian securities law defines this securities misinformation loss in two distinct ways: first, by defining what kinds of investment losses count and, second, by defining how much of these losses are compensable. While there is no theoretical reason why securities law must play such a central role in defining the scope of a securities misinformation insurance program, there are practical benefits. Using securities law to define the scope of covered losses holds constant the kinds and amounts of investment losses that are compensable and, thus, places a sharper focus on the potential effects of creating a new form of insurance to facilitate that compensation. In addition, confining securities misinformation insurance to legally compensable losses may make securities enforcement history a better guide to pricing.[1]

Institutions that presently address securities misinformation loss in Canada include investment diversification mechanisms, civil liability, liability insurance, government enforcement, and self-regulatory organizations. The sections that follow briefly describe these institutions, setting the stage for the discussion of securities misinformation insurance that follows.

i. Investor Diversification

Modern finance theory and research teach that investors can protect themselves against firm-specific risks by holding a diversified portfolio.[2] This means that investors do not, in theory,

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[1] The recent adoption of secondary market liability reduces the value of history for predicting Canadian misinformation insurance losses See R.S.O. 1990, c.55, § 138. *See also* William Braithwaite and John Ciardullo, *Canada's new liability law focuses first on deterrence*, 2004 INT'L FIN. L. REV. 25 (2004).

[2] *See generally* Edwin J. Elton, Martin J. Gruber, Stephen J. Brown, William N. Goetzmann, MODERN PORTFOLIO THEORY AND INVESTMENT ANALYSIS (6th ed 2003). Behavioural finance research provides

need a new insurance program to spread their exposure to securities misinformation loss. If they have enough assets, they can do this themselves. Otherwise, they can create a diversified portfolio by investing in mutual funds. This possibility and its importance for evaluating the need for securities misinformation insurance are discussed in more detail in Section 5.5. For the moment the important point is that investors already have a low cost way to spread their Canadian securities misinformation losses – by holding a diversified portfolio of Canadian securities.[3] This fact distinguishes securities misinformation risks from the risks addressed by the existing forms capital markets insurance listed at the outset (e.g. bank deposit insurance) and undercuts the loss-spreading justification for a new securities misinformation insurance program.

ii. Private-Party Civil Liability

Provincial law provides for private plaintiff civil liability actions for securities misinformation losses in both the primary and secondary securities markets.[4] For the primary securities market, the most important basis for liability is misrepresentation in the prospectus.[5] For the secondary securities market (i.e. trading in already-issued securities), the most important basis for liability is the new secondary market liability regime recently enacted in Ontario (and proposed in British Columbia).[6] In addition, innocent counterparties to insider trading and affected institutions may bring actions to recover damages and disgorge benefits from insiders.[7]

These liability regimes define the misinformation losses that would be covered by a securities misinformation insurance program. Although this report does not aim to describe private-party civil liability in detail, several features of the new Ontario secondary market private-party civil

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considerable reason to doubt that investors in fact adequately diversify their investments. See, e.g., Shlomo Bernartzi and Richard Thaler, *How Much is Investor Autonomy Worth?* Working Paper 2002 (available on SSRN.com) (reporting research that suggests that even when choosing among investment funds investors do not pick the portfolio that is best based on their own criteria).

[3] See Burton Malkiel, A RANDOM WALK DOWN WALL STREET at 224 (2nd ed 2001) (including accounting fraud in a list of firm-specific risks that investors can reduce through diversification: "the whole point of portfolio theory is that, to the extent that stocks don't move in tandem all the time, variations in the returns from any one security tend to be washed away or smoothed out by complementary variations in the returns from other securities"). The extent to which securities misinformation losses are diversifiable is addressed in part II.

[4] See Jeffrey G. MacIntosh and Christopher C. Nicholls, SECURITIES LAW at 161 & 248 (Irwin Pub. 2002); Braithwaite & Ciardullo, supra note 1.

[5] OSA section 130, discussed in MacIntosh & Nicholls supra note 4, at 161 et seq.

[6] See Braithwaite and Ciardullo, supra note 1.

[7] See MacIntosh & Nicholls, supra note 4, at 248-49.

liability bear mentioning. First, the legislation allows investors to recover from the issuer and other defendants simply by proving a securities violation in relation to a "core document",[8] without the *scienter* requirement of U.S. securities law, subject to the following liability caps:

- For an issuer: the greater of $1 million or 5% of market capitalization (determined in the period immediately following the correction of the misinformation).
- For a corporate "influential person": the greater of $1 million or 5% of the market capitalization of the corporate influential person.
- For an individual director, officer or "influential person": the greater of $25,000 or 50% of the individual's compensation during the preceding 12 months.
- For an expert (e.g., a "gatekeeper" such as an auditor or lawyer): the greater of $1 million or the revenue earned from the issuer or its affiliates during the preceding 12 months.[9]

Except for the cap on the issuer's liability, all of these caps are lifted if the investor proves that the defendant's violation was "knowing" (a level of knowledge that appears likely to be more demanding than the *scienter* requirement under U.S. securities law).[10]

The damages rules under the legislation also favour investors in two further respects:

- Plaintiffs are entitled to a straightforward, easily computable damages assessment, with defendants bearing the burden of proof to show that the presumed damages were in fact not caused by the violation.[11]
- Attorneys' fees are to be paid by the losing party in addition to the damages in the event of a successful civil liability action.[12]

[8] R.S.O. 1990, c.S.5., § 138.1 (e.g., prospectus, annual and interim financial statements, management discussion and analysis).
[9] R.S.O. 1990, c.55, § 138.1 & 138.7. See also R.R.O. 1990, REGULATION 1015, part XVI § 249.
[10] R.S.O. 1990, c.55, § 138.7(2).
[11] R.S.O. 1990, c.55, § 138.5.
[12] R.S.O. 1990, c.55, § 138.11. Although fee shifting provisions are often thought to be a pro-defendant reform, the medical malpractice experience suggests that these provisions benefit plaintiffs more than defendants, principally because defendants have assets (most importantly liability insurance) from which to pay the fees far more often than plaintiffs. See Herbert M. Kritzer, *Lawyer Fees and Lawyer Behaviour in Litigation: What Does the Empirical Literature Really Say?* 80 TEX. L. REV. 1943-83 (2002). An institutional plaintiff in a securities fraud case would be somewhat more like a defendant in a malpractice case (without the insurance).

In theory these investor protection aspects of the Ontario legislation will allow Canadian securities litigation to provide quicker and more complete compensation to investors than does U.S. securities law. Turning theory into reality will require the development of an active plaintiffs securities litigation bar.

iii. Liability Insurance

Most publicly traded companies purchase directors and officers (D&O) insurance,[13] and it is common practice for the experts who are subject to potential securities liability (e.g., accountants, lawyers, underwriters) to purchase professional liability insurance. D&O insurance typically provides coverage both for the directors and officers and for the corporation for its own liability in connection with claims against directors and officers.[14] Research shows that D&O insurance almost always provides complete protection for directors and officers who are defendants in private-party civil liability securities actions. These individuals only very, very rarely have to pay any of the damages from their own funds, except for cases in which the director or officer acted with a high degree of wrongful intent.[15] While typically D&O insurance policies exclude coverage for fraud by a director or officer, as a practical matter such allegations usually settle with the underwriter accepting liability rather than running the risk that at trial damages are awarded but fraud is not established.[16] Even private-party civil liability claims against the issuer

[13] Tillinghast Towers Perrin, 2003 DIRECTORS AND OFFICERS LIABILITY INSURANCE SURVEY at 21 (reporting that 92% of public companies in Canada purchase D&O insurance).
[14] See generally Joseph P. Monteleone & Nicholas J. Conca, Directors and Officers Indemnification and Liability Insurance, 51 Bus. Law. 573 (1996).
[15] See Bernard S. Black, Brian R. Cheffins & Michael Klausner, *Outside Director Liability,* 58 STANFORD L.REV. 1055 (2006); Bernard S. Black, Brian R. Cheffins & Michael Klausner, *Outside Director Liability Across Countries*, SSRN abstract 438321 (2004) (considering Canada among other countries). The recent WorldCom and Enron settlements, which required directors to pay out of their own pockets, are recent exceptions in the U.S. that may prove the rule about the absence of actual director and officer liability. *See* Gretchen Morgenson, *Ex-Directors at WorldCom Settle Anew,* N.Y. TIMES (Mar. 19, 2005) (describing agreement according to which former WorldCom directors will personally contribute to settlement amount).
[16] Significantly, this fraud exclusion is commonly subject to a “final adjudication” condition that obligates the insurer to fund the criminal and civil defense of directors or officers unless and until the fraud is finally adjudicated *in the proceeding for which coverage is sought. See* John H. Mathias, Jr., Timothy W. Burns, Matthew M. Meumeier, Jerry J Burgdoerfer, Directors and Officers Liability: Prevention, Insurance and Indemnification at 8-14 (2003) (collecting cases holding that “if the exclusion requires a final adjudication, that adjudication must take place in the underlying action for which coverage is sought”). Because shareholder litigation almost always is settled (and, therefore, not “adjudicated”), the Fraud exclusion does not have the impact that a simple reading of the D&O insurance policy might suggest. Mathias et al, supra note – at 8-15 (noting that the application of the final adjudication provision “drastically diminishes the force and effect of the [actual fraud] exclusion.”). Moreover, for any officer or director subject to such

itself typically are settled within the limits of the issuer's D&O insurance policy,[17] although there may be a trend in the U.S. of increasing numbers of settlements above the policy limits.[18] There has been less systematic research on private-party civil liability actions brought against gatekeepers such as accountants or lawyers, but anecdotal evidence suggests that these claims also are typically resolved by settlements within the limits of the available insurance policies.[19]

In combination, the available evidence strongly suggests that liability insurance covers the substantial majority of the civil damages paid for securities violations, certainly in the U.S. and very likely in Canada. This means that Canada and the U.S. already have securities misinformation insurance of a sort. Defendants purchase this insurance as protection against the costs of securities liability claims, rather than to provide compensation to investors. But, to the extent that defendants are held liable, the risks that are spread are largely the same, despite the fact that the investor is only the incidental beneficiary of the liability insurance.[20] Like investors' diversification options, the fact that securities misinformation losses already are spread by third-party liability insurance provides a reason to question the compensation justification for a new insurance program.

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final adjudication, there almost always are others who do not come within the scope of the exclusion yet had opportunity to prevent or reduce the impact of the fraud. Some more recent policies contain broader fraud exclusions, but these exclusions have not yet been tested. Id.

[17] See, e.g., James D. Cox, *Making Securities Fraud Class Actions Virtuous*, 39 ARIZ. L. REV. 497, 503-504 (1997). The Cox article does not provide strong support for this assertion. Based on ongoing qualitative research, I can report that D&O insurance industry insiders believe that most securities action are settled within D&O insurance policy limits, at least in the U.S. See Baker & Griffith, *infra* note 36. Using U.S. data, Cornerstone reports that "over 65% of all [securities class action] settlements in 2004 were for less than $10 million" (well below the typical D&O insurance policy limit for a publicly traded corporation) and that only 7 settlements were larger than $100 million. See Laura E. Simmons & Ellen M. Ryan, POST-REFORM ACT SECURITIES SETTLEMENTS; UPDATED THROUGH DECEMBER 2004 (Cornerstone Research 2005). Small cap companies typically have D&O insurance policies in excess of $20 million, and large cap companies typically have D&O insurance policy limits in excess of $100 million. See Tillinghast Towers Perrin, 2005 DIRECTORS AND OFFICERS LIABILITY SURVEY.

[18] See Elaine Buckberg, Todd Foster, Ronald I Miller, RECENT TRENDS IN SHAREHOLDER CLASS ACTION LITIGATION: ARE WORLDCOM AND ENRON THE NEW STANDARD? (NERA 2005)

[19] There is a substantial theoretical literature on gatekeeper liability in the securities context. See, e.g., John C. Coffee, Jr., *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. REV. 301 (2004); Assaf Hamdami, *Gatekeeper Liability*, 77 S. CAL. L. REV. 53 (2003-04); Frank Partnoy, *Barbarians at the Gatekeepers?: A Proposal for a Modified Strict Liability Regime*, 79 WASH. U. L. Q. 491 (2001); Stephen Choi, *Market Lessons for Gatekeepers*, 92 NW. L. REV. 916 (1997-98)

[20] While there are exclusions in D&O insurance policies for intentional harm, these exclusions do not appear in practice to limit D&O insurers' liability because there are almost always some beneficiaries whose liabilities do not fall within an exclusion. See Black et al. *supra* note 15.

iv. Government Enforcement

Securities law enforcement in Canada takes place at the provincial and territorial level of government, with the result that the agencies involved vary by province and territory. Most of the enforcement activity takes place in the provinces in which the leading business centres are located: Ontario, British Columbia, Quebec, and Alberta. Consideration of the scope and intensity of government enforcement lies well beyond the bounds of this project,[21] but it is important to remember that the money needed to set up and administer securities misinformation insurance program could be used instead to strengthen government enforcement.

v. Self-Regulatory Organizations

The Investment Dealers Association of Canada and the Mutual Fund Dealers Association each regulate to some degree the conduct of their members, and Market Regulation Services, Inc. regulates trading on the Toronto Stock Exchange and certain other markets.[22] These self-regulatory organizations (SROs) have the authority to investigate and discipline their members and other designated parties, both for violations of securities laws and of their bylaws and regulations. Sanctions include fines and the suspension or revocation of approval to trade or work in a member firm.[23] SROs have created investor protection funds to compensate investors for losses due to the bankruptcy of an SRO member. The existence of these funds suggests that a SRO would have the authority to establish a securities misinformation insurance program for its members, were it to conclude that such a program would be beneficial. Accordingly, one of the scenarios developed in part II involves a fund established by the TSX to protect investors from securities misinformation losses relating to shares traded on the TSX.

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[21] For discussion of Canadian securities enforcement see Poonam Puri, *Enforcement Effectiveness in the Canadian Capital Markets*, CMI Working Paper (December 2005).
[22] RS regulates the following markets: TSX, TSX V, CNQ, Bloomberg, Liquidnet, and BlockBook. See http://www.rs.ca/en/home/ (last visited March 19, 2006).
[23] See MacIntosh & Nicholls, supra note 4, at 75-77.

5. Insurance Issues

Having described in very general terms the institutional landscape into which a new securities misinformation insurance program would fit, it is now time to describe the various forms this program might take. This Section introduces a set of theoretical issues that inform the design of insurance institutions generally and discusses these issues in the context of securities misinformation insurance. This discussion will sharpen some of the earlier questions about the need for this new kind of insurance and suggest a way to think about the potential costs and benefits. Section 6 will describe the main design variables that would affect the form and function of this insurance and how these variables affect the costs and benefits of the insurance. Section 7 will outline three scenarios that illustrate these variables in combination and then compare and contrast them.

i. Moral Hazard

Moral hazard is a longstanding concern in the insurance trade that 20th century economists generalized as part of the economics of information.[24] The basic idea is an intuitive one: insurance against loss reduces the incentives to avoid loss. "Moral hazard" is the name given to that effect on incentives. In the securities context, providing misinformation insurance to what the new Ontario secondary market liability legislation describes as "influential persons" (e.g., controlling shareholders) or to corporate insiders could create a moral hazard by reducing the downside risk of their participation or acquiescence in securities violations. Providing misinformation insurance to other securities holders could also create a (less serious) moral hazard by reducing their incentive to avoid investing in firms that pose a higher risk of securities violations. For this latter, larger class of investors the degree of moral hazard depends on the extent to which non-insiders can accurately identify firms that pose a higher securities misinformation risk.[25]

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[24] See Tom Baker, *On the Genealogy of Moral Hazard*, 75 TEX. L. REV. 237 (1996).

[25] Some readers have suggested that a securities misinformation insurance program would reduce investors' incentive to diversify their investments and reward investors who failed to do so. On reflection, this seems unlikely because securities misinformation is just one of a host of risks that affect investment value. For this reason, the marginal impact of reducing or eliminating that single risk would be unlikely to change the overall incentive to diversify. At most it would affect the expected return of classes of investments that are more exposed to securities misinformation risk and, thus, potentially change the relative share of those investments in a diversified portfolio. At a macro level, this would be the main goal of a Canadian

Like principal agent problems generally, moral hazard is a matter of degree, and there are strategies to manage it. As this suggests, the fact that securities misinformation insurance presents a potential moral hazard problem does not provide a reason to reject that insurance. Rather, the challenge is to design the insurance to address the moral hazard concerns and then to evaluate whether the resulting program would serve a useful purpose. Common strategies for managing moral hazard that could be used for securities misinformation insurance include deductibles and co-insurance (requiring the investor to share in the loss) and subrogation (allowing the fund to seek redress from responsible parties). In addition, the program could be designed so that little or no benefits would be provided to influential persons, insiders, or others with enhanced monitoring or control opportunities. Finally, as a member of the Task Force noted, the reputation damage to individuals who wish to "remain in the game" would also help to counteract the moral hazard of securities misinformation insurance.

ii. Adverse Selection

Adverse selection is another longstanding concern in the insurance trade.[26] As with moral hazard, the basic idea is intuitive: someone who knows that she is more likely to suffer a loss will value insurance against that loss more highly than someone who knows that she is less likely to suffer that kind of loss. Provided that individuals have reliable information about their risk of loss, the dynamics of adverse selection mean that high-risk individuals will disproportionately populate voluntary insurance arrangements, unless the insurer is able to take adequate countermeasures (such as identifying high-risk individuals and charging them a higher price).

In the securities misinformation insurance context at least, adverse selection poses much less public policy concern than moral hazard. Although adverse selection can in some cases prevent the formation of an insurance pool, adverse selection problems rarely pose significant problems to properly designed insurance arrangements[27] and would be unlikely to do so in the securities

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securities misinformation insurance program: making the target class of securities (whether Canadian regulated or traded securities) relatively more attractive to investors.

[26] See Tom Baker, *Containing the Promise of Insurance: Adverse Selection and Risk Classification*, in Richard Ericson and Aaron Doyle, eds., RISK AND MORALITY (U. Toronto P. 2003) (also published at 9 CONN. INS. L. *J.* 371). Adverse selection is sometimes called "anti-selection" in the insurance trade.

[27] See Peter Siegelman, Adverse Selection in Insurance Markets: An Exaggerated Threat, 113 Yale L J. 1223 (2004).

misinformation context. Mandatory participation requirements, if enforced, always take care of adverse selection. Moreover, risk-based pricing can reduce adverse selection to a considerable extent, as long as the entity that purchases the insurance does not have too great an information advantage. Even then, purchasing the insurance can be sufficiently desirable that low-risk entities choose not to drop out of the insurance pool even if prices do not fully discriminate on the basis of risk. For example, entities that purchase public D&O insurance surely have an information advantage over their D&O insurers with regards to the propensity of the particular directors and officers to commit securities law violations, yet purchase of D&O insurance is widespread among publicly traded companies in Canada,[28] demonstrating that this information imbalance does not lead to an unsustainable degree of adverse selection.

iii. Risk Aversion

Risk aversion is the term given to individuals' preference for certainty. Risk aversion is one of the primary justifications for insurance. From one perspective, insurance simply redistributes money from winners (people who do not suffer loss) to losers (people who do suffer loss). All the people involved in the insurance enterprise must be paid, so this redistribution is not free. Absent some reason for understanding why winners and losers would want to contract in advance for this redistribution, insurance might appear simply to increase the total costs of loss by imposing these additional transaction costs. Risk aversion helps explain why insurance does more than simply impose additional transaction costs. (The other reasons are the related benefit of diversification and the positive externalities of insurance, both of which are discussed shortly.) People derive a real benefit from reducing their exposure to risk, a benefit that can be more substantial in the aggregate than the transaction costs required to run the insurance operation.

iv. Loading Costs

Loading costs is the insurance term for these transaction costs.[29] Loading costs vary significantly, from a low of one half of one percent for U.S. Social Security retirement benefits[30] to thirty

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[28] *See* Tillinghast, *supra* note 13. *Cf.*, John E. Core, *The Directors' and Officers' Insurance Premium: An Outside Assessment of the Quality of Corporate Governance*, 16 J. L. ECON. & ORG. 449 (2000).

[29] Karl Borch, ECONOMICS OF INSURANCE 163 (1990) (describing the "loading" of the insurance contract as the difference between expected claims payments and the insurance premium).

percent for property casualty insurance in the aggregate[31] (and even higher for title insurance). Loading costs for Social Security retirement benefits are so low for a variety of reasons: marketing and underwriting expenses are nearly zero due to mandatory participation and strict income-based premium payments; investment costs are nearly zero due to the pay-as-you-go nature of the funding mechanism and the limitation of trust fund investments; and loss adjustment expenses are very low due to the ease of determining eligibility.

Loading costs for a securities misinformation insurance program would depend on how the program is designed. Thus full consideration of loading cost issues must wait for presentation of the design variables in the next section. In the meantime, one point of comparison is directors' and officers' liability insurance, which has loading costs that consume between 20 to 30 percent of premiums.[32] Although a mandatory securities misinformation insurance program would not have all of the same administrative expenses as D&O insurance (for example, sales expenses would be much lower), it would have some administrative expenses that D&O insurance does not. For example, claims-handling costs for D&O insurers are lower than some other forms of casualty insurance because D&O insurance includes the costs of defending the securities liability claims as part of the indemnity payments (i.e., defence costs count against the policy limit), rather than as part of the loss adjustment expense as is the case in most other forms of liability insurance. By contrast, with a securities misinformation insurance program, the costs of determining liability and damages would be part of the loss adjustment expense. The insurance program will not compensate investors unless it is satisfied that there were securities violations and that the investors were damaged; that process seems likely to be expensive.

Moreover, unless the new insurance program eliminated civil liability, issuers would continue to purchase D&O insurance. Thus, the premiums that the issuers would pay for securities misinformation insurance would come on top of their D&O insurance premiums. Yet, unless the

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[30] See Congressional Budget Office, ADMINISTRATIVE COSTS OF PRIVATE ACCOUNTS IN SOCIAL SECURITY, Chapter 3 (2004) (reporting administrative costs of $2.1 billion for 2002, benefit payments of $388.1 billion, and revenue (payroll taxes plus investment income) of $539.3 billion), available at: http://www.cbo.gov/showdoc.cfm?index=5277&sequence=0&from=0#anchor According to the Council of Canadians, the loading costs for Canadian public pensions is about one percent. See http://www.canadians.org/display_document.htm?COC_token=024ZY24&id=62&isdoc=1&catid=87

[31] Insurance Information Institute, Insurance Fact Book.

[32] Marc Siegel, *The Dilemmas in the D&O Market: Where Do We Go from Here?* Presentation at 2006 D&O Symposium of the Professional Liability Underwriting Society, February 1, 2006 (available at http://www.plusweb.org/Downloads/Events/Dilemmas_in_The_DO_Market.ppt).

program is designed to substantially increase the rate of claiming, the compensation paid to defrauded investors would remain largely the same (except in cases in which the damages exceed the available insurance limits and the issuer or other liable party becomes insolvent).

v. Diversification

Diversification is what enables insurance institutions to spread individuals' losses, providing the main benefit that makes the insurance loading costs worth incurring. Insurance can spread the losses of the unfortunate few (for whom risk matures into loss) because of the premiums paid by the many (for whom the risk does not mature into loss). Diversification has become such a focus in the finance field generally that it is easy to forget that insurance institutions pioneered diversification. Remembering this history, however, poses an immediate challenge to the concept of insurance as a protection against investment loss. If the main benefit of insurance is diversification, why do we need insurance for a risk that can be diversified much more cheaply in other ways?

Holding a diversified portfolio provides investors with substantial protection against investment losses from securities fraud by limiting the portion of any individual's assets that are invested in firms that commit securities fraud. Moreover, private-party civil liability already provides a way for investors to obtain some compensation for their securities misinformation losses. Securities misinformation insurance would further reduce the securities misinformation losses of a diversified investor. But it would do so at the price of decreasing the gains from the rest of the investor's portfolio – because of the premiums for the insurance paid by the issuers of these other securities. Thus, for a diversified investor, a securities misinformation insurance program would be an expensive way to take money out of one pocket (the portion of the portfolio that does not suffer securities misinformation losses) in order to put it into another (the portion of the portfolio that does suffer such losses).[33]

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[33] The following thought experiment illustrates this point:

1. Assume a market that is efficient except that investors cannot identify which entities will violate securities laws. In that situation the market will discount securities prices to take into account securities misinformation. Assume that discount is 5%.
2. Now assume mandatory securities misinformation insurance that provides complete protection for securities misinformation at no cost to issuers or investors. Securities prices would immediately rise 5% (because the market would no longer be discounting securities prices to take into account securities misinformation).

As this discussion should make clear, questioning the need for securities misinformation insurance on loss-spreading grounds does not require that securities misinformation losses be diversifiable in the strong sense that holding a diversified portfolio would essentially eliminate that risk. Indeed, securities misinformation losses almost certainly are not diversifiable in that strong sense. Some portion of securities misinformation losses surely is systemic. For one thing, securities misinformation losses are likely to be biased in one direction. While there is some evidence that insiders sometimes withhold good news,[34] disclosure violations seem more likely to involve the failure to announce bad news. In addition, asset bubbles may increase the likelihood of securities violations, and the bursting of a bubble surely increases the likelihood that violations will be detected, suggesting not only that the losses are biased in one direction, but also that they are correlated to at least some degree.

When evaluating the institutional advantage of securities misinformation insurance, the question is not whether holding a diversified investment portfolio eliminates securities misinformation risk, but rather whether a new insurance program is a better strategy for spreading securities misinformation losses than investor diversification. Because the loading costs of insurance are so much greater than the relatively small fees required to purchase a diversified investment portfolio, the answer almost certainly is "No."

Investors' existing ability to spread losses - and also obtain compensation in cases covered by the Ontario legislation - without the insurance constitutes a fundamental difference between securities misinformation losses and losses addressed by existing forms of capital markets insurance. These capital markets insurance programs protect individuals from losses that cannot otherwise adequately be spread or compensated. Pension guaranty funds protect individuals with defined benefit pension plans from the insolvency of their employer – a risk that employees

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3. Now assume that all the firms with securities trading in the market have to pay for that insurance, but that there are no transaction costs. Securities prices immediately fall 5% (because the market is now bearing the misinformation losses in the form of insurance premiums).
4. Now allow for the existence of transaction costs. Securities prices fall further, below the original 5% discount (because the insurance premiums will be greater than the total misinformation losses, reflecting insurance loading costs).

[34] *Cf.*, Charles Forell, *Five More Companies Show Suspicious Option Patterns*, WALL STREET JOURNAL, May 22, 2006 (reporting that the suspicious pattern could be the result of dating the options ahead of the release of good news or, more likely, backdating); *SEC Files Insider Suit Tied to Bid for Placer*, WALL STREET JOURNAL, November 3, 2005 (reporting purchase of call options in advance of announcement of takeover attempt).

otherwise could not diversify. Insurance guaranty funds protect individuals from the insolvency of their insurer – a risk that insurance policyholders otherwise could not diversify. Broker/dealer insurance funds protect individuals from the insolvency of their broker or dealer – a risk that investors cannot realistically manage through diversification.[35] Bank deposit insurance protects depositors from the insolvency of their bank – a risk that they cannot realistically manage through diversification. Because individuals cannot adequately diversify their exposure to these other risks on their own, we can be reasonably certain that these other forms of capital markets insurance provide substantial social welfare benefits (because of the risk aversion of the individuals insured), notwithstanding the transaction costs imposed. By contrast, individuals already can spread their securities misinformation losses without a new securities misinformation insurance program.

But what about non-diversified investors? Surely they would benefit from the diversification provided by a new securities misinformation insurance program.

I think not, with the limited exception of investors who are unable to diversify (for example employees in defined contribution pension plans that are shaped in a way that favours investing in the employers' securities). The better solution for these investors would be removing the obstacles to diversification. There are two reasons. First, even non-diversified investors have access to private-party civil liability actions to obtain compensation. Although civil liability is not yet well-developed in Canada, it does provide compensation for some losses, and the new Ontario legislation is promising. Thus, the policy choice the Task Force is facing is not between no compensation and complete compensation. Rather, the choice is between some compensation and more compensation. Second, although non-diversified investors surely would prefer to receive compensation after a loss has occurred, the relevant question is what they would prefer before a loss. Before the loss, non-diversified investors have revealed a preference that suggests that they would not value securities misinformation insurance. Holding a diversified portfolio would protect these investors from all firm-specific ways to lose money, and distributing risk through diversification is nearly free. Investors who pass up the opportunity to distribute all these risks, nearly for free, would be unlikely to adopt an expensive risk distribution strategy for a

[35] While investors could reduce their exposure to the risk of broker/dealer insolvency by using multiple brokers, that would be so inconvenient for many investors that they would seem unlikely to adopt that strategy.

single category of investment risk – unless there is something qualitatively different about securities misinformation risk, as compared to other firm-specific risks.

Some members of the Task Force suggested that a securities misinformation insurance program might facilitate "merit-based investing" (i.e. investing to beat the market) and, thus, the insurance would in fact provide non-diversified investors with a service that they would value. The idea is that the risk of fraudulent information is qualitatively different from other firm-specific losses because merit-based investing depends on accurate information. Whether merit-based investors would therefore find securities misinformation insurance sufficiently valuable to offset the loading costs imposed on all investors is ultimately an empirical question. My intuition suggests it is not, but reasonable people could disagree.

What we can say with some certainty is the following: diversified investors do not need securities misinformation insurance to spread securities misinformation risk, and non-diversified investors may not want it (before a loss). Thus, the case for securities misinformation insurance would be much stronger if it rested on something other than investor compensation and loss-spreading. The case would be much stronger if it rested on *systematic* benefits for the Canadian securities market, in other words on the positive externalities of the insurance.

vi. Positive Externalities

"Positive externalities" is the economic term for the benefits that a transaction provides to people other than the parties to that transaction. The positive externalities of insurance can be quite substantial, as suggested by government support of insurance institutions around the world and by the fact that the generic term for government-supported retirement, disability, and health insurance is "social security." Would securities misinformation insurance create positive externalities? If so, would those benefits outweigh the loading costs?

If there are positive externalities, they should be reflected by increased demand – and therefore increased prices – for securities traded on the Canadian market. Pushing in the other direction would be the drag on earnings from the loading costs of a new securities misinformation insurance program. The loading costs are a certainty. Increased demand for Canadian securities is not. Where might that increased demand come from?

a) Improved Compliance

One possibility is that securities misinformation insurance would improve securities law compliance and reduce securities misinformation losses over time. Whether this improved deterrence/compliance would be enough to offset the increased loading costs is an empirical question that cannot be answered in advance.[36] Nevertheless, there are two reasons to believe that securities misinformation insurance might accomplish this goal. First, a monopoly securities misinformation insurer would have significant institutional advantages over existing directors' and officers' liability insurers with regard to loss prevention and management. Second, a securities misinformation insurer also could have institutional advantages over government and SRO enforcement agencies in the detection and prosecution of securities violations.

Institutional advantages over D&O insurers. Ongoing research suggests that D&O insurers do not in fact perform as much governance as theory would suggest.[37] In theory, a liability insurer can be expected to govern the behaviour of insurance applicants in several ways: pricing on the basis of risk and thereby creating an incentive to reduce loss; conditioning insurance on compliance with loss prevention requirements; providing loss prevention advice that customers follow in order to reduce uninsured aspects of their loss; and providing loss management services, *ex post*, that draw on the insurers' repeat player experience in the liability arena. D&O insurers in fact provide very little of this governance, except through price, and even price-based governance is less developed than commonly believed. The most parsimonious explanation for this situation is that corporate managers sufficiently value the autonomy that comes from purchasing D&O insurance as a pure, risk-spreading service that they are willing to pay more for that insurance notwithstanding the moral hazard.[38] D&O insurance is sold in a competitive market with

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[36] It would be difficult to answer after the fact as well, if only because the recent adoption of the secondary market liability would make it difficult to determine whether the new liability or the new insurance is responsible for any observable change.

[37] *See* Tom Baker and Sean Griffith, *The Missing Monitor in Corporate Governance: The Directors' and Officers' Liability Insurer* (working paper). See also Tom Baker and Sean Griffith, *Predicting Corporate Governance Risk: Evidence from the Directors' and Officers' Insurance Market* (working paper) (describing D&O insurance market and D&O insurance underwriting process). *Cf.,* Sean Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' & Officers' Liability Insurance Policies*, 154 U. PENN. L. REV. 1147 (2006) (arguing that D&O insurance purchases and prices should be disclosed because of the governance information reflected in the price).

[38] See Baker & Griffith, *Missing Monitor*, *supra* note 37.

comparatively low entry costs, so an insurer that insisted on bundling unwanted governance features with the risk-spreading that buyers want would be quite unlikely to succeed.

A monopoly securities misinformation insurer with a captive market would be a very different entity than a D&O insurer. D&O insurers have little choice but to eschew the efforts that insurers take to control moral hazard in other liability insurance contexts.[39] By contrast, a monopoly securities misinformation insurer would not be constrained by management's preference for insurance that promotes management autonomy. Subject only to the limits on underwriting authority imposed by the authorizing legislation or sponsoring organization, the securities misinformation insurer could require issuers to adopt any loss-prevention practices that it deemed beneficial.[40] Subject to the same qualification, the insurer could adopt any loss-management practices that it deemed beneficial as well. Moreover, because the securities misinformation insurer would be involved in every securities claim,[41] the insurer could develop a comprehensive database of firm and claim characteristics that, in theory, would provide a more reliable basis for evaluating the effectiveness of different corporate governance measures than any single D&O insurer can develop at present.[42]

Institutional advantages over government and SRO enforcement agencies. While there would be legitimate concern that a securities misinformation insurer might resist the payment of claims in the first instance, once the insurer pays those claims it would have a significant incentive to recover the cost of those claims through subrogation against the responsible parties. This incentive distinguishes the securities misinformation insurer from government and SRO enforcement agencies, which are not empowered to seek and retain for the agencies themselves securities misinformation losses from the responsible parties.[43]

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[39] *Id*.

[40] Whether a strong, non-accountable securities market regulator of this sort is desirable is beyond the scope of this report. Because the conditions that cause securities misinformation losses are not well understood, I have concerns that the insurer might require practices that did not in fact prevent losses or that inappropriately interfered with issuers' core business operations. Because the insurer would hold a monopoly, there would not be a market check on such over-regulation.

[41] Except under the "excess" or "backstop" approach discussed in the design variables section.

[42] *But see* Baker & Griffith, *Predicting Risk*, *supra* note 37 (finding that D&O insurance underwriters focus on "deep governance" factors that are difficult to categorize across firms).

[43] Under paragraph 127(1)(10) of the Securities Act (Ontario), the OSC 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

b) Signalling of Quality

A second potential benefit of securities misinformation insurance comes from the signalling function of that insurance, similar to the signalling function that economists attribute to generous product warranties. In the economics literature, consumers are understood to pay attention to warranties, not primarily because they actually 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.[44] Adopting a securities misinformation insurance program could signal that Canadian issuers are so confident of the transparency of the Canadian securities market that they are willing to buy insurance protecting investors for securities misinformation losses. On the other hand, as a member of the Task Force suggested, investors could regard the insurance as an indication that there is so much fraud in the Canadian market that the insurance is needed to induce people to invest. The widespread advertising of good warranties in other markets suggests that consumers do not in fact regard warranties as a signal of poor quality. Nevertheless, this comment usefully emphasizes the importance of framing and, thus, counsels the use of an appropriate advertising and public relations campaign in connection with the implementation of any securities misinformation insurance program.

vii. A Cost-Benefit Summary

As noted several times already, investor compensation and loss-spreading provide weak justifications for securities misinformation insurance. The loading costs would certainly exceed

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[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 <u>for allocation to or for the benefit of third parties</u> ." [Emphasis added.] Thank you to Jeffrey R. Elliott of Stikeman Elliott LLP for elucidation of this point.

[44] *See* Sanford J. Grossman, *The Informational Role of Warranties and Private Disclosure about Product Quality*, 24 J. L. & ECON. 461 (1981) (suggesting that this signalling function is particularly important for new products, a category that presumably would include old products with newly improved quality); Joshua L. Weiner, *Are Warranties Accurate Signals of Product Reliability?*, 12 J. CONSUMER RES. 245 (1985). *Cf.* Robert D. Cooter and Ariel Porat, *Anti-Insurance*, 31 J. LEG. STUD. 203 (2002) (suggesting that it would be efficient to assign warranty rights to a third party in situations involving consumer moral hazard and labelling this assignment "anti-insurance"). It is worth noting that that private party civil securities liability functions as partial anti-insurance to the extent that class action firms "purchase" the warranty rights by agreeing to serve without ex ante compensation and then receive a significant part of the warranty benefits in the form of ex post fees that are deducted from the recovery to the class.

the loss-spreading benefits for an investor with a diversified portfolio of Canadian securities (because the insurance would simply move money from one part of that portfolio into another). The non-diversified investor has already revealed a preference against risk-spreading, and therefore may not value this mandatory, insurance-based diversification. Promoting broader, market-based diversification would provide greater benefits to currently non-diversified investors, without the loading costs of an insurance program.

Thus the case for securities misinformation insurance would be stronger if it could rest on systematic benefits for the Canadian securities market. The potential systemic benefits are a) increased demand due to enhanced investor confidence, and b) reduced securities misinformation losses due to improved securities law compliance.

Will the increased investor confidence offset the drag on earnings caused by the new insurance premiums? Can a securities misinformation insurance program sufficiently improve securities compliance so that misinformation losses decline sufficiently over time to offset the loading costs?[45] These are empirical questions that cannot be answered in advance. Nevertheless, they do provide a way to think about the cost-benefit balance of any new securities misinformation insurance program. If the benefits of the new program are to exceed the costs, then the answer to one or both of these empirical questions must be "Yes". Otherwise, the costs of the program will outweigh the benefits.

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[45] Note that this does not require that D&O and securities misinformation insurance premiums actually decline. At present it seems very likely that many securities misinformation losses are not compensated and, thus, are not reflected in D&O insurance premiums. An effective new securities misinformation insurance program would compensate a higher percentage of the eligible investors and, thus, have reporting effects. The combined D&O and securities misinformation insurance premiums would likely be higher than D&O insurance premiums, alone, at present even if the new program reduces the overall amount of securities misinformation loss.

6. <u>Design Variables</u>

A securities misinformation insurance program could take many forms. For present purposes, the most important design variables are the following:

- The definition of the misinformation event that triggers the right to insurance benefits,
- Whether the program is primary or excess in relation to existing private-party civil liability,
- The designation of beneficiaries and benefits,
- The funding mechanism,
- Claims procedures,
- Rules regarding subrogation, and
- Whether participation is to be mandatory.

The subsections that follow briefly describe these design variables. In order to avoid an extended, abstract discussion, Section 7 outlines three different securities misinformation insurance scenarios that provide the basis for a more concrete discussion.

i. The Misinformation Event

In this report "securities misinformation insurance" has been defined as insurance against securities misinformation loss, with "securities misinformation loss" defined simply as legally compensable investment loss from violation of Canadian securities laws. Under this definition, the misinformation event would be a violation of the securities laws that causes legally compensable investment loss. Using existing securities laws to define the misinformation event serves the practical purposes identified earlier, most importantly isolating the effect that providing first-party liability insurance would have on the securities market and compliance. Although the program could be defined to cover a broader or narrower range of investment losses, consideration of this possibility should be left to securities law enforcement experts if and when the decision to adopt a securities misinformation insurance program has been made.

ii. Primary or Excess

The question here is whether an investor may recover first from the securities misinformation insurance program or whether the investor must first pursue a civil liability claim against the responsible parties. Either way, the investor is entitled to compensation only when securities laws are violated and, thus, the securities misinformation insurance would be a form of liability insurance. Unlike traditional, third-party liability insurance, however, the injured party would be the direct beneficiary of the insurance. Thus, securities misinformation insurance would be a form of *first-party* liability insurance.

The leading examples of first-party liability insurance are workers compensation insurance and under/uninsured motorists insurance. For present purposes, the most significant difference between these two forms of first-party liability insurance lies in their relationship to other forms of compensation that are available to the beneficiary. Workers compensation insurance is "primary" insurance for a work-related accident, meaning that the worker can collect directly from the workers compensation insurer without first having to pursue other avenues of redress. By contrast, under/uninsured motorists insurance is "excess" insurance for an automobile accident, meaning that the auto accident victim must first attempt to recover from the liability insurer of the responsible driver. Only if the responsible driver does not have – or does not have enough – liability insurance, can the victim collect from his or her own under/uninsured motorists insurance.

Securities misinformation insurance could be designed either way. Under a primary insurance approach, a security holder could file a claim for benefits with the insurance program without first attempting to recover from the responsible parties and their insurers. In that case, the securities misinformation insurance program presumably would have the right to seek indemnification from the responsible parties. (This subrogation possibility is discussed in more detail below.) Under an excess insurance approach, the security holder would first have to obtain whatever recovery it can from the responsible parties, and the insurance fund would compensate the investor only when the defendant does not have enough insurance or other assets.

Under a primary insurance approach, the securities misinformation insurance program could well become one of the central institutions in the securities law enforcement and compensation field.

This approach could offer substantial opportunities to improve securities law enforcement by creating a well-funded, subrogation-hungry securities litigation repeat player, but the loading costs would be correspondingly substantial. Under an excess insurance approach, the insurance program could be more peripheral, and much less expensive, as long as potential defendants purchase adequate liability insurance, most importantly D&O insurance.[46]

iii. Beneficiaries

The obvious beneficiaries of securities misinformation insurance are investors with legally compensable misinformation losses from Canadian securities violations. The most significant beneficiary-related design questions relate to possible distinctions among different subsets of this group. Moral hazard concerns counsel distinguishing between investors who have the ability to control or monitor securities law compliance from investors who do not. Arguably, shareholders with control should not be covered at all, and shareholders with enhanced monitoring abilities should be covered at a lower level.[47]

In one of the scenarios described below, the insurance applies only to securities traded on the TSX. This raises another important beneficiary-related design question: How to treat investors with identical securities purchased on more than one exchange? If the goal is to promote the use of the TSX, then a "last in, first out" decision rule (in which the most recently purchased securities are regarded as the ones that were first sold) would encourage buyers to trade on that exchange. If the goal is to reward historical use of the exchange, then a "first in, first out" decision rule, (in which the most recently sold securities are regarded as the first purchased securities) would be preferable. If the goal is to provide the maximum protection to investors,

[46] The auto insurance situation illustrates the importance of this caveat. Uninsured motorists insurance was first conceived as providing occasional protection for the unusual situation in which the driver could not be found or failed to buy insurance. But under/uninsured motorists insurance has become one of the main institutions of auto accident compensation because so many drivers purchase very low limits of liability protection. Note that this concern is addressed in Scenario 2 by suggesting that the insurance fund adopt a policy of not pursuing the private assets of individuals covered by a reasonable amount of insurance, except in situations involving aggravated fault. This policy would encourage individual directors and officers to make sure that corporations purchase a reasonable amount of D&O insurance on their behalf.

[47] Of course this would require defining how much control and monitoring ability are enough: A broader definition of "insiders"? Shareholders with greater than X% of the outstanding shares? Specific classes of investors, such as hedge funds? If the program is intended to promote trading on the TSX, a member of the Task Force pointed out a countervailing concern: investors who are excluded from the benefits would not be encouraged to trade inter-listed securities on the TSX. These important beneficiary design details would need to be resolved by securities law experts in the event an concrete proposal is developed.

then the first securities disposed of should be considered the securities purchased on the specified exchange.

iv. Benefits

Securities misinformation insurance would compensate beneficiaries for all or part of their legally compensable securities misinformation losses. The main benefits design question is "How much of the covered losses should be compensated?" Even in the U.S., which appears to have more robust securities enforcement and compensation institutions than Canada, most investors who incur legally compensable misinformation losses probably are not compensated at all, and those who are compensated receive payments that make good only a portion of their losses.[48] Thus, even a moderately successful securities misinformation insurance program would be likely to provide substantially more compensation than currently provided through civil liability. Moreover, because investor diversification already provides a low cost way to spread securities misinformation losses, deterrence and corrective justice objectives are more important from a public policy perspective than loss spreading. For these reasons, and because of residual concerns about investor moral hazard, it would be advisable for investors to share in the loss.

The investor share could be borne in the form of a deductible (meaning that the first $X of the loss are not compensated), a cap (meaning that losses per investor, per loss event beyond $Y are not compensated), coinsurance (meaning that the insurance covers only Z% of the loss), or some combination of these. Caps represent a rough-and-ready way to address both moral hazard and fairness concerns. Perhaps for that reason they are common in other capital market protection programs, such as bank deposit insurance and insurance guaranty funds. In light of the new Ontario secondary market liability, one possible approach would be to cap the securities misinformation insurance benefits at the level of the liability limits that are available to investors in the absence of a knowing violation.[49] The investors' right to pursue additional compensation

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[48] *See* Simmons & Ryan, *supra* note 17 (reporting that settlement amounts are a small percentage of damages). To my knowledge there has not been research in the securities fraud arena that is analogous to the research done by RAND in the accident arena, comparing the rate of claiming to the rate of injuries. *See, e.g.*, Carroll, Stephen and Allan Abrahamse, *The Frequency of Excess Auto Personal Injury Claims*, 3 AM. L. AND ECON. REV. 228 (2001); Deborah R. Hensler et al, COMPENSATION FOR ACCIDENTAL INJURIES IN THE UNITED STATES (Santa Monica, CA: RAND 1991). That research shows that most people do not claim. It would take a heroic assumption about the efficiency of existing securities class action litigation to conclude securities misinformation losses are different in this regard.

[49] *See* TAN 9, *supra*.

for a knowing violation might be transferred to the securities misinformation insurer, which would then split any recovery with investors, perhaps on a 50/50 basis. This possibility is discussed further in the claims procedure section below and adopted as one of the key features of the first scenario.

v. Funding

Funding may well present the most complex design issues, starting with the question of who should pay the premiums for the insurance program. Potential premium payers include issuers, sellers in the secondary market, buyers, and intermediaries. In theory it is the investors who ultimately bear the costs in the form of reduced earnings, but different ways of collecting the premiums can affect how different classes of investors share those costs.

Moral hazard, adverse selection, and fairness concerns all counsel linking premiums to risk. For example, if the frequency of trading affects securities misinformation risk (which seems likely since a buy-and-hold investor will be less likely to suffer a securities misinformation loss than an active trader[50]), then at least some portion of the premiums should be paid along with a trade so that the frequent traders internalize that increased risk. Similarly, underwriters of directors and officers insurance in the U.S. believe that M&A activity and public offerings increase securities misinformation risk.[51] For that reason, a securities misinformation insurance program might be designed to require the payment of additional premiums in connection with those (and other) risk-increasing activities.

As noted earlier, risk-based pricing is the main form of insurance as governance in the D&O market. But risk-based pricing is less developed in that market than might be expected: the risk factors for securities misinformation losses are not well understood and very few factors have been quantified to any reliable extent.[52] Thus, the pricing for a securities misinformation insurance program should be designed to allow for experimentation and learning.

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[50] As explained in the companion report of Professor Harry Panjer, the secondary market liability legislation provides a cause of action only to investors who traded during the misinformation period, so a buy-and-hold investor is much less likely to incur a legally compensable loss than a frequent trader.

[51] See Baker & Griffith, *Predicting Risk*, *supra* note 37.

[52] The primary quantifiable risk factors that D&O insurance underwriters presently use in the U.S. are market capitalization, industry group, and measures of share price volatility. In addition, underwriters report that they adjust D&O premiums up or down on a discretionary basis to reflect soft factors such as

In addition to providing an appropriate incentive to issuers, risk-based premiums have the potential to provide an interesting new source of information to the securities markets.[53] While the premiums likely would be based on information that already is available to the market, the aggregation and transmission of that information in the form of a risk-based premium would be new. This is one illustration of an important point: a securities misinformation insurance program could have unpredictable and unintended consequences.

Other funding design questions include the following: Who determines what the premiums will be? How and when? Subject to what review? How strongly committed should the program be to pre-funding? What provision will there be for assessments in the event that losses exceed program reserves? While important, these questions can be deferred until a decision to adopt a securities misinformation insurance program is made.

vi. Claim Procedures

Claims procedures will be very important, both because of the impact on loading costs and because the claims process would become part of the overall securities law enforcement mechanism, especially under a primary insurance model.

Under any approach to securities misinformation insurance, there is an important conceptual distinction between the procedures for determining whether a misinformation event took place (i.e. that a Canadian securities violation caused at least some investment loss) and the procedures for determining who is entitled to what benefits as compensation for this securities misinformation loss. The collective action problem resulting from dispersed ownership of securities presents a significant challenge to the design of the first procedure (which will be referred to as the Step 1 procedure). If a particular claimant bears the cost of the Step 1 proceeding but can only benefit from the proceeding to the extent of her own harm, too few Step 1 proceedings will be attempted.

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prior claims activity, recent or upcoming M&A activity or public offerings, corporate governance, and their assessments of the character of the CFO and other top executives and the culture of the corporation. *Id.*

[53] *Cf.* Lawrence A. Cunningham, *Choosing Gatekeepers: The Financial Statements Insurance Alternative to Auditor Liability*, 52 UCLA L. REV. 14 (2004) (predicting that disclosure of FSI insurance premiums would affect securities prices); Griffith, *supra* note 36 (predicting that disclosure of D&O insurance premiums would affect securities prices).

Under an excess insurance model, the claims procedures would be comparatively straightforward. Step 1 would consist of a private-party civil liability action. Step 2 would involve demonstrating to the securities misinformation insurer that Step 1 was complete and that the damages were not collectible.[54] As can be readily seen, an excess insurance approach does not provide an independent solution to the collective action problem and, thus, would not improve securities law enforcement. In effect, an excess insurance model simply guarantees the solvency of the responsible parties for purposes of paying securities misinformation claims (up to the limits of the insurance benefits).

Under a primary insurance model, there is no comparatively obvious approach to claims procedures. One approach might be to rely on a government or SRO enforcement agency to investigate and determine whether a securities law violation has occurred. But this would do nothing for securities misinformation losses that were not investigated by enforcement agencies or that were resolved without admissions of fault by the responsible parties. Thus, there must be some way for investors to bring the equivalent of a private-party civil liability action within the context of the insurance program. If this new insurance-based claiming process simply shifts the forum of investors' civil liability actions from the courts to the securities misinformation insurance claims process, however, it is hard to see what is gained, especially because the securities misinformation insurer would then turn to the courts to enforce its subrogation rights against the responsible parties.

This latter point illustrates what might seem, at first, to be a fundamental incoherence in the very idea of primary, first-party liability insurance in situations in which the liable parties ordinarily have assets that are worth pursing. Workers compensation insurance – a successful form of primary, first-party liability insurance – is easily distinguished, because the historic workers compensation bargain released employers from liability as long as they purchased workers compensation insurance for their employees.[55] Thus the obvious responsible party (the employer)

[54] An important fine point concerns actions resolved by settlement. To guard against ex post moral hazard, claimants should be required either to obtain the consent of the insurance fund before resolving a case by settlement or to demonstrate after the fact that the settlement was reasonable.
[55] David Moss, SOCIALIZING SECURITY: PROGRESSIVE-ERA ECONOMISTS AND THE ORIGINS OF AMERICAN SOCIAL POLICY (Harvard U. P. 1996).

cannot be pursued except in unusual circumstances.[56] No-fault auto insurance – a form of primary insurance that replaces liability – also is easily distinguished. No-fault insurance reflects a political judgment that compensating auto accident victims is more important than using civil liability to deter auto accidents (in part because of a belief that civil liability is not an effective deterrent in the personal auto context).

The securities misinformation insurance context is very different. Liable parties regularly have assets worth pursuing.[57] Moreover, as suggested by the political judgment reflected in the new Ontario secondary market liability regime (most significantly the liability caps), deterrence is more important than compensation in the securities context.[58]

If there were an existing, well-functioning liability system that adequately solved the collective action problem, then a first-party liability insurance program in fact would make little sense. But if there is not, then a primary, first-party insurance program may help solve the collective action problem, provided that a) investors can more readily collect from the insurer than from the liable party, and b) the insurer then aggressively pursues subrogation actions against the liable parties.

Building on the two-tiered approach of the new Ontario secondary market liability regime provides a significant opportunity for a primary securities misinformation insurance program to improve on liability alone. Recall that the new Ontario legislation has generous, investor-friendly damages rules, but limits the liability of potential defendants unless investors meet what appears to be a difficult "knowing violation" test.[59] Thus, there will in some instances be a substantial gap between the damages that a defendant caused and the liability that the defendant is obligated to pay, absent proof of a knowing violation.

Similar to the underlying liability regime, a primary securities misinformation insurance program could be structured to pay benefits up to the "limited-fault" liability caps upon satisfactory proof of a violation (perhaps under the "likely to succeed" standard used for preliminary injunctions in the U.S.), in return for receiving from the investors an assignment of their claims against the

[56] See Arthur Larson, ed., LARSON'S WORKERS COMPENSATION (Matthew Benson 2001).
[57] A member of the Task Force commented that defendants often do not have sufficient insurance or other assets in the Canadian securities fraud context. If so, that strengthens to some degree the compensation justification for securities misinformation insurance (subject to the diversification discussion earlier).
[58] Braithwaite & Ciardullo *supra* note 1.
[59] See TAN 9, supra.

potentially responsible parties. The assignment would grant to the securities misinformation insurer the right to receive complete compensation for the benefits that it provided, plus the right to proceed on behalf of the investors against the defendants for additional damages under the uncapped, knowing violation standard, with the securities misinformation insurer to receive an appropriate percentage of any additional recovery as compensation (50%?) for taking the risk and funding the action.[60] Absent this insurance arrangement, an investor cannot take the comparatively sure thing – the "limited-fault" damages – while at the same time preserving the ability to collect on the long-shot, uncapped, knowing violation damages.[61] Instead, the investor faces a choice between settling quickly for the limited-fault capped amount or waiting for the resolution of a longer, more costly knowing violation litigation. The two-tiered payment and assignment approach sketched here has the potential to improve deterrence, in effect by creating the market in civil liability that commentators have suggested in various forms.[62]

vii. Subrogation

Subrogation is the legal term given to the right of an insurer to step into the shoes of a beneficiary in order to recoup from other liable parties what the insurer has paid to, or on behalf of, the beneficiary. For example, health insurers in the U.S. commonly obtain reimbursement from automobile insurance companies for the cost of treatment for medical injuries from auto accidents. Similarly, a workers compensation insurer can obtain reimbursement from an auto insurer for benefits paid in a work-related auto accident or from a manufacturer for benefits paid

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[60] A very helpful discussion with Professor Jill Fisch provided the germ of this idea.

[61] The closest available settlement device is the high/low agreement, which is common in personal injury litigation. Under a high/low agreement the plaintiff and defendant agree to go to trial but they limit their exposure by agreeing that, no matter what the jury does, the plaintiff gets at least the low amount and the defendant will not have to pay more than the high amount. Securities actions go to trial far less frequently than personal injury actions, and there are no reports of high/low settlements (perhaps because securities class action settlements require judicial approval; it is hard to imagine a judge approving a settlement that contemplated a trial). The securities misinformation insurance payment and assignment approach just described provides plaintiffs with all the security of a high/low agreement, with less sacrifice, and more quickly.

[62] See, e.g., Jill E. Fisch, *Class Action Reform, Qui Tam, and the Role of the Plaintiff*, 60 LAW & CONTEMP. PROBS. 167 (1997); Jonathan R. Macey & Geoffrey P. Miller , *Auctioning Class Action and Derivative Suits: a Rejoinder*, 87 NW. L. REV. 458 (1993); Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Actions and Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. CHI. L. REV. 1 (1991); Jean Wegman Burns, *Decorative Figureheads: Eliminating Class Representatives in Class Actions*, 42 HASTINGS L. J. 165 (1990).

for a work-related products liability injury.[63] Subrogation would be a major feature of a securities misinformation insurance program only if the program provides primary insurance. (With an excess approach, the plaintiffs presumably will already have recovered from the responsible parties, thus there will in the ordinary case be no need for subrogation).

The obvious potential targets for subrogation actions include officers and directors, accountants and other gatekeepers, and the issuer itself. The arguments for and against subrogation are similar to the arguments for and against liability in the first instance. The main difference is that there are no compensation-based justifications for subrogation.[64] In addition, the presence of securities misinformation insurance reduces shareholders' incentive to prevent misinformation loss, making the deterrence and corrective justice arguments for subrogation even stronger than those for liability in the first instance.

In many circumstances, the main problem with subrogation is that it increases loading costs due to the potential for double litigation (or even triple litigation in the event of a dispute over whether the liability insurance covers a particular subrogation action). Ordinarily, these additional loading costs provide further reason to doubt the compensation and loss spreading rationale for any new first-party liability insurance, especially if the victims have other ways of spreading their losses. Once again, however, the two-tiered nature of the new Ontario secondary market liability provides an opening to argue, first, that the additional costs will be less than might seem (because the initial decision to pay the limited liability level of benefits can be made in summary fashion, without extensive fact-finding) and, second, that these additional costs will produce substantial deterrence benefits.

vii. Participation Requirements

Most forms of capital markets insurance are mandatory, whether as a matter of law or practice. Bank deposit insurance, pension guarantee funds, broker/dealer protection funds, and insurance guarantee funds are not optional for the institutions for which they exist.

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[63] For a discussion of how subrogation works in practice in the U.S. tort context, see Tom Baker, *Blood Money, New Money, and the Moral Economy of Tort Law in Action*, 35 LAW & SOCIETY REV. 275, 301 et seq. (2001).

[64] In other contexts, subrogation may promote compensation by reducing the cost of first party insurance and, thus, allowing more people to purchase that insurance. Here, subrogation would shift costs to D&O insurance, arguably making that insurance more expensive than it is at present due to reporting effects.

Securities misinformation insurance could be mandated by provincial law (like insurance and pension guarantee funds), federal law (like bank deposit insurance), or by membership requirements in a self-regulatory organization (like investor protection funds). Mandatory participation requirements could make the securities misinformation insurance fund a very significant gatekeeper. Provided that the fund engages in risk-based underwriting, there presumably will be some potential securities issuers that the fund decides are too risky to insure at a price the issuer is able to pay, with the result that potential issuer will have to raise capital in some other way. From a loss-prevention perspective, this gatekeeper function is a good thing, but there may be a political pushback, another potential unintended consequence of securities misinformation insurance.

Whether mandatory participation is necessary to prevent adverse selection is an empirical question. Risk-based pricing would reduce the adverse selection concern. If investors really value securities misinformation insurance, issuers would use the insurance coverage as a selling point (much as banks in the U.S. now use “FDIC insured” as a selling point for certificates of deposit) and, thus, may be willing to participate in a voluntary system. On the other hand, if the goal of the insurance is to improve securities enforcement, then participation in the program may increase the chance that a securities violation would be detected. While that might reduce issuers’ initial interest in the product, it would also increase the quality signal provided by the insurance and, thus, potentially increase the premium investors would pay for insured securities.

7. Scenarios

This Section describes three securities misinformation insurance scenarios. The objective is to provide concrete examples that will facilitate analysis of the potential costs and benefits of securities misinformation insurance, as well as the comparative advantages of different approaches to the design variables just discussed. In the first scenario a new single-purpose organization modeled on the Canadian Deposit Insurance Corporation administers the primary securities misinformation insurance program. In the second scenario a new industry-supported Canadian Securities Fraud Protection Fund administers a securities misinformation insurance program that applies to securities traded on the TSX. In the third scenario private market insurers provide the insurance in response to demand stimulated by a new disclosure requirement.

i. Government-provided primary insurance: CIIC

This first scenario is a more fully developed, Canadian version of an insurance program briefly suggested in the conclusion of David Skeel's *Icarus in the Boardroom* (2005).[65] In this first scenario, a new Crown corporation modeled on the Canadian Deposit Insurance Corporation – the Canadian Investor Insurance Corporation (CIIC) – provides the securities misinformation insurance. The CIIC insurance benefits are primary, meaning that investors can collect benefits from the CIIC without first having to bring private actions against securities violators.

> Beneficiaries: All securities holders who demonstrate through specified claims procedures that they have suffered a legally compensable investment loss from a Canadian securities law violation. (N.B. The moral hazard of providing insurance to influential persons and other insiders is addressed through Step 2 of the claims procedure sketched below.)

[65] Sean Griffith, *Daedelean Tinkering*, 104 MICH. L. REV. 1247 (2006) (reviewing David Skeel, IACARUS IN THE BOARDROOM (Oxford U. P. 2005), and criticizing Skeel's investor protection insurance idea on diversification grounds similar to those discussed in section 5.5 of this report). Almost all of the specifications and design features of this scenario are presented and analyzed for the first time in this Report.

Benefits: The legally compensable damages available under private-party civil liability actions, subject to the limited fault liability caps of the Ontario secondary market liability legislation.

Funding: The CIIC is funded in three ways, none of which impose any financial burden on the general revenues of the government:

1. All investors in Canadian securities traded in Canadian markets pay a small per-trade fee (proportional to the value of the trade), collected by securities dealers.[66] (The purpose of the per-trade fee is to reflect the increased exposure to securities misinformation losses from trading.)

2. Issuers of Canadian securities will pay annual, risk-based premiums set by CIIC using best actuarial practices, with a special emphasis on risk factors that are within the control of issuers. (The likely initial risk factors are those presently used in the private D&O insurance market.)

3. If securities misinformation losses reduce the reserves of the CIIC below a target level, issuers may be assessed additional amounts (similar to that for the Canadian life insurance guaranty fund, Assuris). CIIC would have authority to borrow funds (secured by future assessments) to cover operational shortfalls.

Claim procedures:

Step 1: Any affected investor may demonstrate that a Canadian securities violation has caused an investment loss in one of two ways:

1. By providing proof of an enforcement proceeding alleging that fact and resolved through adjudication or a settlement with an admission of fault; or

[66] Note that this could discourage trading on Canadian exchanges for inter-listed securities. An alternative would be to require a per trade fee for a Canadian issued security no matter where it is traded. Whether that is legally possible or enforceable is beyond my expertise.

2. By initiating a private investor proceeding with the CIIC. CIIC will establish the procedures and proof requirements for the private investor proceeding through a consultative process with the SROs and experts in the fields of securities law, administrative and civil procedure, and insurance. For transactions subject to the Ontario secondary market liability legislation, this procedure will be designed to facilitate prompt and inexpensive proof of the limited-fault liability established in that legislation. One approach would be to establish a "likely to succeed on the merits at trial" standard as the trigger for payment of the insurance benefits.[67]

Step 2: Once CIIC determines that a Canadian securities law violation has caused a legally compensable investment loss, CIIC will use available databases to identify investors who suffered legally compensable loss and to make a preliminary determination of the amount of their loss. CIIC will then provide that information to each investor, explaining the benefits to which the investor appears to be entitled and providing the opportunity for an appeal of the initial determination. Subject to an administrative appeal procedure, payments will be made accordingly. Any payments to the issuer, directors or officers of the issuer, controlling shareholders or other potential subjects of a subrogation proceeding will be placed in escrow pending a decision regarding subrogation. A decision by the CIIC to commence a subrogation proceeding against an individual or entity will result in the forfeiture of any CIIC benefits for which the individual or entity might otherwise have been entitled in connection with the loss to which the subrogation proceeding relates.[68]

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[67] Although the use of this standard would likely result in the CIIC paying benefits in some cases in which it was not able to recover those benefits from the responsible parties, the CIIC should be able to fund those benefits through the recoveries it obtains for knowing violations in other cases.

[68] In effect, the subrogation action would create a non-rebuttable presumption of liability to the extent of any CIIC benefits that would otherwise be due. An alternative approach suggested by one Task Force member would be to place the benefits in an escrow fund that would be released if the subrogation action was not successful. I prefer the approach in the main text because of the moral hazard involved in providing benefits to this class of investors in the first place.

Subrogation: As a condition of making payments under the fund, CIIC will obtain the broadest possible subrogation rights from all claimants. CIIC will bring subrogation actions when appropriate in the exercise of its discretion. Subrogation to the extent of the CIIC benefits will almost always be appropriate. In addition, the CIIC will have the authority to seek compensation for additional damages to investors, such compensation to be shared by the CIIC and the investors on a 50/50 basis after deducting (a) all of the CIIC's costs of collection and (b) an administrative fee that will cover the expenses incurred in processing the CIIC benefits.[69]

Participation requirements: All issuers subject to Canadian securities law are required to pay insurance premiums. All investment dealers and exchanges are required to ensure that the per-trade fee is paid.

One member of the Task Force suggested consideration of an opt-out for institutional investors, in effect allowing them to make the decision whether to diversify against securities misinformation risk. As a practical matter, an-opt out would work only for per-trade fees, not for premiums paid by issuers (because the institutional investor would bear the proportional cost of any issuer paid fees through reduced earnings). Thus, for an opt-out option to be real, the primary funding for the program would have to be per trade fees. To avoid strategic behaviour in an opt-out system, an opt-out made in connection with any trade should be regarded as a complete opt-out for that investor with regard to the securities of that issuer.

Role of private market insurers: Private market insurers are not involved in the provision of securities misinformation insurance. Because the underlying liability regime is maintained, and subrogation encouraged, the market for D&O insurance remains.

ii. Industry-Provided Excess Insurance: SFPF

In this scenario, the Toronto Stock Exchange mandates that issuers whose securities trade on the exchange must participate in a new securities misinformation insurance program to be called the Canadian Securities Fraud Protection Fund. (Alternatively, the program could be made a part of

[69] Note that these additional recoveries will be used to cover CIIC costs and to permit the CIIC to charge lower premiums.

the existing Canadian Investor Protection Fund, which presently protects investors from the insolvency of their investment dealers). The new program would be excess to civil liability, meaning that the investors would first have to bring a private-party civil action against the responsible parties.

Beneficiaries: All investors who have successfully concluded a Canadian private-party civil liability action relating to securities purchased on the Toronto Securities Exchange but have been unable to collect all their legally compensable damages.

Benefits: Same as for CIIC in Scenario 1 above, with three important differences:

- The SFPF benefits are excess to a civil liability recovery;
- The benefits are limited to losses relating to securities traded on the TSX;[70]
- In the event that the investors have established liability beyond the limited fault liability of the Ontario secondary market liability legislation, the total benefits to all issuers will be capped at 10% of the market capitalization of the issuer at the time of the misinformation event.[71]

For investors who purchased securities on more than one exchange, the first shares sold during the misinformation period will be regarded as the shares purchased on the TSX.

Funding: Issuers pay risk-based premiums set by the SFPF using best actuarial practices.[72] (The most important risk factor is likely to be credit risk.) If securities misinformation losses reduce the reserves of the SFPF below a target level, issuers may be assessed additional amounts (similar to that for the Canadian life insurance guarantee

[70] A Task Force member commented that, if benefits were limited to shares traded on the TSX, the fiduciary obligations of institutional investors would require them to trade inter-listed securities on the TSX so that their participants would receive the benefit of the insurance. If trading on another change is less costly and if the institutional investor holds a sufficiently diversified portfolio, I would expect that the contrary argument would be made. Namely, the institutional investor would argue that it was already protecting its participants from securities misinformation (and all other firm-specific losses) by holding a diversified portfolio and, therefore, the prudent place to purchase the securities would be on the cheaper exchange.

[71] This (arbitrary) 10% cap comes from doubling the 5% cap in the new Ontario secondary market legislation.

[72] The program would also be funded all or in part through per-trade fees.

fund, Assuris). The SFPF has authority to borrow funds (secured by future assessments) to cover operational shortfalls.

Claims procedures:

Step 1: Claimants successfully conclude a private civil liability action. As a condition of eligibility for SFPF benefits, civil liability actions resolved through settlement must be approved by court order entered with the consent of the SFPF.[73]

Step 2: Claimants must demonstrate:

- Satisfactory completion of Step 1;
- Legally compensable damages relating to trades on TSX;
- These damages have not been fully compensated;
- All applicable liability insurance has been exhausted and
    - Each corporate defendant has paid (or been assessed) its liabilities in full or become insolvent or otherwise unavailable
    - Each individual defendant who has not paid his or her liabilities in full has paid (or been assessed) amounts that are reasonable in light of the gravity of the violation, the individual's participation, and the adequacy of the limits of insurance protecting the individual.[74]

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[73] This consent requirement is intended to prevent claimants and defendants from structuring settlements to take advantage of the SFPF by, for example, shifting the D&O money and other assets to claimants who did not trade on the TSX. Consider whether the SFPF might in an appropriate case accept a partial settlement and assignment of the right to proceed against the non-settling defendants in return for payment of the securities misinformation insurance benefits. If so, this might allow the SFPF to fill a broader enforcement role than might be expected given the excess nature of the insurance protection.

[74] This final factor maintains the incentive to insure. This standard is similar to the norm in personal injury practice, in which plaintiffs typically do not attempt to collect from defendants' personal assets except in the case of aggravated fault or failure to purchase adequate insurance. See Baker, *Tort Law in Action*, *supra* note 63. Routinely collecting from the assets of individual defendants in securities litigation would represent a dramatic departure from current practice. The norms in settlement of securities fraud actions appears to require contribution from individual defendants only when the defendant was actively engaged in and profited from the fraud, or, more rarely, when the magnitude of the fraud was extreme. See Black *et al. supra* note 15.

Appeal: In the event that a claimant is not satisfied with the recovery from the SFPF, the claimant may bring an action in the Toronto Divisional Court, which will review the decision for abuse of discretion. All actions relating to a single loss event will be consolidated.

Subrogation: As a condition of making payments under the fund, SFPF will obtain the broadest possible subrogation rights from all claimants. SFPF will bring subrogation actions (i.e. civil liability actions in the names of the investors it compensated) when appropriate in the exercise of its discretion. Because this is an excess approach, subrogation typically will be used only to collect damages assessed in the private-party civil litigation.

Participation requirements: All issuers whose securities trade on the TSX are required to pay premiums.[75]

Role of private market insurers: Private market insurers are not involved in the provision of securities misinformation insurance. Private market insurers will continue to provide D&O and professional liability insurance. As noted, the claims process will be structured to maintain the incentive for individuals and entities to purchase D&O and professional liability insurance.

iii. Private Market Insurance: SPI

In this scenario, one or more provincial legislatures enact legislation that requires securities issuers to obtain securities protection insurance from a licensed insurance company or to disclose the decision not to purchase such insurance in every communication with a holder or potential purchaser of a security that it has issued. (Alternatively, the TSX adopts the same disclosure requirement for securities traded on the TSX.) The securities protection insurance is excess first-party liability insurance.

[75] The opt-out possibility discussed in connection with the CIIC scenario could be considered in this situation as well.

Described in the language of the insurance trade, the new securities protection insurance would function as if it were a Difference In Conditions (DIC) policy that is excess to the liability insurance policies of all the potential defendants to a private-party civil liability action relating to an issuer that purchased the insurance. The securities protection insurance would drop down in the event that any of this liability insurance is uncollectible for any reason (including the application of any exclusions) and it would be available in the event of exhaustion of the liability insurance.

This is broader coverage than provided in excess liability insurance policies presently on the market. None of the typical exclusions in D&O or professional liability insurance policies would apply (e.g., intentional harm), and it is a real question whether the insurer should be permitted to rescind the policy because of fraud in the application. The securities protection insurance would differ from a true excess DIC policy, however, in that the insurer would be permitted to subrogate against any or all of the defendants in the securities claim. Thus, as long as the entity that purchases the policy is sufficiently solvent, a defrauded insurer should be able to be made whole through subrogation. Thus, credit risk would be an extremely important aspect of the underwriting decision, if any insurer were to decide to offer the insurance.

> <u>Beneficiaries:</u> Investors who have successfully concluded a Canadian private-party civil liability action relating to securities of an issuer that purchased the insurance, but have been unable to collect all their legally compensable damages.
>
> <u>Benefits:</u> The legislation (or TSX rule) would specify a minimum benefit level to qualify as investor protection insurance. Issuers would be free to purchase and advertise that they have purchased higher levels of protection. For purposes of discussion, assume that the minimum benefit is 75% of legally compensable securities misinformation losses with a cap of $250,000 per investor per loss event.[76]

[76] Obviously this cap would make the insurance unattractive to institutional investors. The program could be designed with a larger cap, but this would make the program even less attractive to insurance companies than it already is. One alternative would be a larger per investor cap combined with an aggregate limit on the policy. Issuers would be free to purchase excess layers of insurance that would increase the aggregate limit. Based on discussions at the Roundtable and my own experience with D&O insurers I doubt that liability insurers would have an appetite for this kind of insurance, unless it were backed by some form of government or industry-sponsored reinsurance (which, presumably, could have the ability to assess issuers in the event of a shortfall).

Premiums: Issuers will pay premiums. The market will set prices. Existing provincial legislation may give insurance regulators some authority to review rates, but that authority is unlikely to be exercised.

Claim procedures:

Step 1: Claimants must successfully conclude a private civil liability action. To be eligible for compensation, claims resolved through settlement must be approved by court order entered after the insurer was provided the opportunity to be heard.

Step 2: Claimants must demonstrate:

- Satisfactory completion of Step 1;
- Legally compensable damages relating to securities of an issuer that purchased the insurance;
- These damages have not been fully compensated;
- All applicable liability insurance has been exhausted and
  - Each corporate defendant has paid (or been assessed) its liabilities in full or become insolvent or otherwise unavailable
  - Each individual defendant who has not paid his or her liabilities in full has paid (or been assessed) amounts that are reasonable in light of the gravity of the violation, the individual's participation, and the adequacy of the limits of insurance protecting the individual.
- If the action was resolved through settlement, that the settlement was reasonable.

Appeal: In the event that a claimant is not satisfied with the recovery from the securities misinformation insurer, the claimant may bring a breach of contract action against the insurer. All actions from a single loss event will be consolidated into a single proceeding.

Subrogation: Subrogation rights are determined by contract. Based on current practice in other private market insurance contexts, the investor protection insurance contracts are likely to include subrogation provisions. As with the SFPF scenario, subrogation will be used to collect damages assessed in the underlying private-party civil litigation. In addition, subrogation would be permitted against the purchasing issuer in the event of fraud in the application.

Participation requirements: Participation is voluntary, but encouraged through the requirement that issuers regularly disclose the absence of such insurance. While voluntary participation could lead to adverse selection, insurers' freedom to price on the basis of risk will mitigate adverse selection. Moreover, if investors respond negatively to disclosures regarding the absence of insurance, low-risk issuers are likely to purchase the insurance even if they have reason to believe that their premiums will subsidize high-risk issuers and that buying the insurance increases the probability that a securities violation will be detected.

Role of private market insurers: This is a private market approach. Whether insurers would be willing to offer this insurance is an open question. The representatives of the insurance industry present at the Roundtable were sceptical of their ability to price this risk and issuers' interest in voluntarily paying for such insurance.

iv. Comparison and Discussion

This section discusses the differences among these scenarios in terms of the design variables introduced in Part C, above. Before beginning that discussion, however, it is important to point out that government sponsorship does not necessarily make the government a guarantor of the insurance benefits (as the CIIC scenario illustrates and as the experience of the Canadian Deposit Insurance Corporation demonstrates[77]). Government sponsorship need not imply a trade-off between support for investors on the one hand and support for the environment, the

[77] See generally, A. Warren Moysey, *Deposit Insurance and Other Compensation Arrangements, Research Paper Prepared for the Task Force on the Future of the Canadian Financial Services Sector* (September 1998).

disadvantaged, or any other potentially more important policy objective on the other. One obvious advantage of federal government sponsorship is the greater reach of federal authority and, possibly, greater investor confidence in the security of a government sponsored fund. If the TSX or other industry organization sponsors the insurance program, investors may be concerned that TSX members will pressure the organization to keep the premiums low, leading to under-funding.

a) The Misinformation Event

All three scenarios defined the misinformation event identically, by reference to Canadian securities law.

b) Primary or Excess

This design variable presents one of the most important differences among the scenarios. The first scenario outlined a primary insurance approach. The second two scenarios outlined excess insurance approaches. Although the first scenario linked government sponsorship with a primary insurance approach, this link is not inevitable. The government could sponsor an insurance fund that paid on an excess basis; the TSX could sponsor an insurance fund that paid on a primary basis; and private market insurers could in theory offer either kind of insurance.

How to make the primary vs. excess choice depends on the securities law enforcement role that is imagined for the insurance program. Under an excess approach, the program in effect provides a limited guarantee of the solvency of potential defendants in securities actions and does not play an important enforcement role. Under a primary approach, the program could become a major force in securities law enforcement.

c) Benefits and Beneficiaries

All three scenarios used Canadian securities law to define the beneficiaries and the compensation that is available to investors. In addition, each of the scenarios also set a cap on the amount of compensation that an investor could receive from the insurance program for any single loss, even if the legally compensable damages were larger. The first scenario capped the total insurance benefits that would be paid for any single misinformation loss at the limited-fault liability limits established in the new Ontario secondary market liability legislation. (Significantly, this scenario established a two-tiered payment and assignment procedure in which investors authorized the insurance fund to obtain additional damages from the responsible defendants on their behalf.) The second scenario capped the total insurance benefits that would be paid for any single loss at 10% of the market cap of the issuer (determined at the time of the misinformation event), and the third scenario capped the benefits for any single investor at the smaller of $250,000 or 75% of the legally compensable losses.

There is no insurance-based reason why either of these latter caps would be optimal. Setting an optimal cap would require deeper knowledge of the securities markets than possessed by the author of this report. The point here is simply to suggest that some kind of cap is needed to address insurance moral hazard concerns (i.e. to maintain the incentive of larger investors to monitor securities law compliance efforts). In addition, a cap facilitates more reliable pricing of the insurance premiums.

d) Funding

Reflecting the political judgment of the participants at the Roundtable, none of the scenarios involves any government guarantees or the use of any government money. All three scenarios assume that the issuers whose securities are covered by the insurance will pay risk-based premiums. The differences among the scenarios concern the presence or absence of per-trade fees and the ability of the insurer to require issuers to pay post-loss assessments in the event that losses consume the reserves of the insurance fund.

The funding design in each of the scenarios reflects the incentives of the institutions involved. The government-sponsored CIIC scenario has both per trade fees and the possibility of post-loss assessments. The TSX-sponsored SFPF scenario has the possibility of post-loss assessments but no per-trade fees. And the private market approach has no per-trade fees and no possibility of post-loss assessments.

There are no per-trade fees in the TSX-sponsored SFPF approach because a per-trade fee would conflict with the goal of making trading on the TSX more desirable. There are no per-trade fees in the private market approach because of the administrative complexity involved in collecting the fees on behalf of multiple private market insurers. There are no post-loss assessments in the private market approach because issuers can choose whether to purchase the insurance or not, and it seems most likely that an issuer would prefer a fixed premium based on risks that are relatively within its knowledge and control rather than an uncertain premium that would be based on risks that are not within its knowledge or control (i.e. the behaviour of other issuers).

e) Claims Procedures

The most significant difference in the claims procedures in the scenarios follows from the primary vs. excess decision. With an excess approach, the claims procedures are comparatively obvious. The two challenges addressed in the scenarios are (1) maintaining potential defendants' incentive to purchase liability insurance (addressed through the "reasonable insurance" rule discussed in the subrogation section of the second scenario) and (2) preventing the parties to the civil liability action from engaging in litigation and settlement tactics that take unfair advantage of the securities misinformation fund (addressed by the "reasonable settlement" rule discussed in the claims procedures section of the second and third scenarios).[78]

With a primary insurance approach the claim-processing design challenges are more substantial. The best justification for a primary insurance approach is improving securities law enforcement. Thus, the challenge is to design a claims procedure that substantially improves on the existing private-party civil liability without over-compensating investors (and therefore increasing the loading costs of the insurance and making investors indifferent to the securities compliance levels of issuers). How to do this lies beyond the expertise of an insurance expert and, thus, the CIIC scenario (Scenario 1) observed that "CIIC will establish the procedures and proof requirements for the private investor proceeding through a consultative process with the SROs and experts in

[78] Note that the claims procedures described in the two excess scenarios differ as follows:

- In the TSX-sponsored scenario (Scenario 2), the consent of the Fund to the settlement of the underlying civil liability action is a condition precedent to eligibility for Fund benefits, and the appeal from the Fund determination of the individual benefit amounts is reviewed under an abuse of discretion standard.
- By contrast, in the private market scenario (Scenario 3), consent of the securities protection insurer to settlement of the underlying action is not a condition precedent; instead the requirement is that the settlement be reasonable. And the appeal from the insurer's determination of the individual benefit amounts is carried out by a breach of contract action (in which case the court makes a de novo determination).

the fields of securities law, administrative and civil procedure, and insurance." The two-tiered payment and assignment approach sketched in this report provides one potentially promising approach to designing a primary securities market insurance program to improve the deterrence function of securities liability.

f) **Subrogation**.

The only differences among the scenarios with regard to subrogation follow from the primary vs. excess decision. Subrogation would be a routine, crucial part of a primary insurance approach. In an excess approach, subrogation would simply be a tool for collecting damages assessed in a private-party civil liability action.

g) **Participation Requirements**.

The participation requirements in the scenarios follow from the underlying goal of the insurance program in question. Presumably, the goal of a federally sponsored program would be to increase the demand for Canadian securities generally; thus all Canadian issuers would be required to participate.[79] The goal of the TSX would be to increase the demand for trading on the TSX, thus only issuers that trade on the TSX would be required to participate. The goal of the private market approach would be to provide the opportunity for issuers to signal the quality of their corporate governance and for investors to make decisions on the basis of that signal; thus, participation would be voluntary. As discussed in the first scenario, it would be possible to design a "mandatory" program to allow an institutional investor to opt out, but, if the opt-out option is to be real, a program with an opt-out option would have to be funded primarily by per-trade fees. Allowing opt-outs would reduce the objection that the securities misinformation insurance program would impose unnecessary loading costs on already diversified investors. But it would also reduce the likelihood that the insurance program would in fact improve compliance.

[79] As one Task Force member commented, an alternative goal would be to encourage trading on specified Canadian exchanges, in which case the program would apply only to securities traded on the exchanges.

h) The Role of Private Market Insurers

Third-party liability insurance would remain a vibrant insurance market in all three scenarios. Only the third scenario relies on the private market to provide the new securities misinformation insurance. In theory the private market would already be providing that insurance if investors were willing to pay for it. But as the underinsured motorists insurance example demonstrates, it is possible for the government to stimulate demand for a new kind of insurance.

8. Conclusion

This report has explored the following topics:

- How securities misinformation risks are addressed in the absence of securities misinformation insurance (investor diversification, civil liability and related liability insurance, government and SRO enforcement);
- The various forms that a new securities misinformation insurance program could take; and
- The kinds of tradeoffs involved in making choices about the main design variables (most significantly the sponsoring organization, whether to provide primary or excess benefits, benefit caps, and claims procedures).

In concluding, the report returns to the cost-benefit analysis left off in the discussion of insurance issues in Section 5, vii. Although that analysis was purely conceptual, it demonstrated that the costs of any new Canadian securities misinformation insurance would outweigh the loss-spreading benefits for investors who hold a diversified portfolio of Canadian securities. For those investors, securities misinformation insurance would simply provide an expensive way to move money from one pocket to another.

Among investors who do not hold a diversified portfolio of Canadian securities, the new insurance would provide loss-spreading benefits to those lucky enough to be able to link their investment losses to Canadian securities violations. But it is doubtful whether, even for non-diversified investors as a whole, the loss-spreading benefits are sufficient to justify the loading costs imposed on the market as a whole, especially as compared to the more broadly beneficial –

and less expensive – alternative of promoting retirement and other investment programs that increase investor diversification as a whole.

Is singling out securities misinformation losses for expensive, insurance-based, mandatory diversification really the best way to protect the non-diversified investor? Encouraging, perhaps even requiring, retail investors to diversify their investments seems likely to provide more substantial benefits at lower cost. Not even the most expensive mutual fund eats up 20 to 30% of the investment in overhead. Yet, that is what will happen to the securities misinformation insurance premiums paid indirectly by all but the relatively few investors lucky enough to: a) have their investments disproportionately invested in securities affected by securities violations, and b) have traded in the right (or should it be wrong?) direction during the misinformation period. Indeed, the average non-diversified, buy-and-hold investor will not derive much benefit from securities misinformation insurance, since a buy-and-hold investor is less likely to be harmed by securities misinformation than a more frequent trader.

On the other hand, because of the importance of accurate information to the functioning of the securities markets, it is possible that non-diversified, "merit" investors would value a diversification program narrowly targeted at securities misinformation risk. A securities misinformation insurance program with an easy opt-out would allow such investors to obtain that protection without imposing the resulting loading costs on diversified investors. On the other hand, easy opt-out would undercut the deterrence objectives of the program.

In sum, loss-spreading provides at best only a very weak justification for securities misinformation insurance, and only for non-diversified investors (and only with easy opt-out). The case for securities misinformation insurance would be much stronger if it could rest on systemic benefits for the Canadian securities markets. There are two candidates:

- Increased investor confidence due to what amounts to a warranty of transparency with regard to the securities protected by the insurance; and

- Reduced securities misinformation losses due to improved securities law compliance attributable to the new insurance program.

How realistic are these benefits? How would we know whether these benefits outweigh the drag on earnings from the loading costs of the new insurance program?

The second of these questions is the easier to answer. To evaluate whether the investor confidence benefits outweigh the insurance costs, one can track price/earnings ratios and more subtle measures of investor confidence before and after the insurance program is announced. If these measures improve, then so has investor confidence, and the benefits may well justify the loading costs.

Evaluating the enforcement benefits would be more difficult, for two reasons. First, the new secondary market liability regimes have just gone into effect, so it would be difficult to determine whether the insurance program or the new liability were responsible for any enforcement benefits. Second, a new insurance program is almost certain to have reporting effects, meaning that the number of securities misinformation claims will increase even if the number of securities misinformation events actually declines.

In any event, precision is not necessary at this point, because the benefits cannot really be quantified with any precision in advance. The decision to proceed depends on the confidence that members of the Task Force have in the likelihood of systemic benefits. A report from an insurance expert cannot provide that confidence. All that it can do is to raise issues, propose a framework for analysis, lay out the design variables, and describe the potential securities misinformation insurance programs in sufficient detail that the Task Force can evaluate whether the systemic benefits are sufficiently probable to justify further work to specify and price a securities misinformation insurance program.

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