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Research Study

The Role of Securities Regulation in Promoting a Competitive Capital Market

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Maintaining a Competitive Capital Market in Canada

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Table of Contents

1. Executive Summary

This paper sets out attributes of a competitive capital market that securities regulation may play a role in promoting. These attributes include: confidence in the market; liquidity; information costs; timeliness of information; transactions costs; agency costs; and certainty of the performance of securities transactions.

The paper examines the role securities regulation may play in promoting these attributes in five main areas of securities regulation: mandatory disclosure; insider trading; market manipulation; takeover bid regulation; and securities industry regulation. The primary role securities regulation plays in all these areas is promoting confidence in the market. In promoting confidence in the market securities regulation can reduce the tendency for investors to discount prices for securities. By reducing the discounting of securities prices, securities regulation can improve the allocation of savings to investment and the allocation of financial resources to productive activities thereby improving the overall economic performance.

Securities regulation can also affect other attributes of a competitive capital market. It can affect market liquidity; information costs; transactions costs; agency costs; and the certainty of performance of securities transactions. Securities regulation, if not carefully crafted, can have a negative impact on the competitiveness of capital markets by, in particular, increasing transactions costs and potentially also increasing information costs, rather than reducing them.

The difficulty with radical reforms of securities regulation in Canada, even where they might provide substantial improvements, is the uncertainty that such reforms might create both domestically and in international markets. This uncertainty may lead to migration of issuers and investors to foreign capital markets. More limited reforms should be considered, and might include, in the context of mandatory disclosure, providing for fully integrated disclosure, reviewing disclosure requirements, and methods to reduce both transactions costs for issuers and information costs. Many of the recommendations of the recent Task Force Report on Insider Trading should be followed and consideration should be given, as suggested by the Task Force, to an approach to insider trading that focuses on whether the person who did the trading had a connection to the information rather than whether the person had a connection to the issuer to which the information relates. In the context of insider trading, consideration should also be given to providing a legislative imprimatur for phantom stock programs.

In the area of takeover bid regulation, consideration should be given to repealing takeover bid requirements and allowing a market-based response. Failing that more radical suggestion, consideration should be given to an opt-out takeover bid regime. Failing *that* somewhat less radical suggestion, consideration should be given to modifying takeover bid regulation to increase first-bidder incentives to make takeover bids and thereby restore the corporate governance monitoring function of takeover bids. This might be done by reducing the bid period or increasing the takeover bid trigger.

More general reforms that should be considered include the adoption of third-party enforcement techniques, a review of securities legislation and rules with an eye to simplification, and continued efforts to harmonize securities regulation across Canada and to work towards simplification of the regulatory structure.

2. Summary of Recommendations

Constraints:

Recommendation #1: Avoid changes to Canadian securities regulation that would make it deviate significantly from approaches taken in other major capital markets.

Disclosure:

Recommendation #2: The integration of disclosure in short form and shelf prospectuses should be extended to all issuers.

Recommendation #3: Prospectus and continuous disclosure requirements should be reviewed with an eye to: reducing specific requirements; simplifying presentation; improving comparability of disclosure; and improving accessibility of information that has been disclosed.

Recommendation #4: Facilitate the search of "other documents" on SEDAR by identifying the documents more clearly.

Insider Trading Regulation:

Recommendation #5a: Identify the types of media that will be considered acceptable for the purposes of providing "general disclosure" of information.

Recommendation #5b: Set a period of time after disclosure through the media described in Recommendation 5a, after which insiders can trade without being subject to insider trading sanctions or civil liability.

Recommendation #6: Add a provision making it clear that where an insider has knowledge of undisclosed information that indicates the securities are worth more than the prevailing market price and directs, or causes, the issuer to issue securities to the insider such a transaction is not exempt on the basis that the insider reasonably believed the issuer had knowledge of the inside information.

<u>Recommendation #7</u>: Follow through with the recommendations of the Task Force Report on Insider Trading with respect to the adoption of best practices for issuers and their directors and senior officers, and for lawyers, accountants, banks and dealers.

<u>Recommendation #8</u>: Follow through with the recommendations of the Task Force Report on Insider Trading with respect to the detection of insider trading.

<u>Recommendation #9</u>: Continue to rely on administrative sanctions as the primary enforcement technique for the prohibition of insider trading and informing.

<u>Recommendation #10</u>: Consider enacting a provision that clarifies that a phantom stock option regime is neither a violation of the insider trading prohibition nor contrary to the public interest if it complies with specified restrictions.

<u>Recommendation #11</u>: Examine the possibility of replacing the current combined "person-connection" and "information-connection" approach to insider trading with just an "information-connection" approach as suggested by the Task Force Report on Insider Trading.

Takeover Bid Regulation:

<u>Recommendation #12a</u>: Repeal existing takeover bid regulations and replace them with a specific requirement that poison pill plans be subject to shareholder approval. Retain the principle in National Policy 62-202 that takeover defences should not deny shareholders of the ability to make fully informed decisions.

<u>Recommendation #12b</u>: In the alternative, instead of repealing the existing takeover bid laws, retain them but allow issuers to opt out of the rules, freeing issuers to adopt rules with less than the minimum requirements provided for under the existing takeover bid rules.

<u>Recommendation #12c</u>: If alternative Recommendations 12a and 12b, above, are not adopted then consider increasing the threshold for takeover bids to something more than 20% to increase returns to first-bidders and thereby improve the agency cost controlling effects of takeover bids.

Enforcement:

<u>Recommendation #13</u>: Consider increased reliance on third-party enforcement techniques.

Other:

<u>Recommendation #14</u>: Review of the legislation with a view to removing provisions that are perhaps no longer necessary, to make the provisions more clearly fit with the move toward rule-based modifications of the regulatory scheme and, where possible, to simplify the language of the provisions.

<u>Recommendation #15</u>: Efforts to address the incremental costs that our multi-jurisdictional regulatory structure may impose should continue. In the short term, this may involve continued efforts at harmonization. In the longer term, perhaps some form of the "passport" approach or joint regulatory body approach can be taken.

3. Introduction

A capital market allocates savings to investment. In a competitive capital market, savings should be allocated to investments that provide the highest rate of return for a given level of relevant risk. Where securities prices in a capital market do not accurately reflect returns on the securities and the relevant risk associated with those returns, there will be a misallocation of savings to investment. Market failures in a capital market may cause investors to demand higher returns to compensate for potential losses associated with the market failures. This raises the cost of capital for issuers, causing them to reduce investment in productive activities with consequent effects on the economy. If the capital market is less competitive than capital markets in other jurisdictions, issuers will have an incentive to raise capital in those other jurisdictions, thereby incurring a lower cost of capital.

If Canada can improve the competitiveness of its capital market, it can improve the allocation of savings to investment, lower the cost of capital and thereby increase its level of production. If Canada can make its capital markets more competitive than other jurisdictions, then it can attract foreign issuers and investors and become a more significant provider of services associated with capital markets.

This paper examines attributes of a competitive capital market and the role securities regulation plays in promoting these attributes. Securities regulation is often said to be about investor protection.[1] Much of what is said to protect investors can also be said to promote attributes of a competitive capital market. Consequently, much of the discussion in the paper focuses on the justifications of various aspects of securities regulation. These justifications for securities regulation have often been questioned, at least in academic circles. The paper thus reviews debates that have occurred on the justification of various aspects of securities regulation. Several reform proposals that have been suggested are also reviewed. The paper concludes with some directions for reform. The directions for reform are modest in nature since more radical reforms, even ones that could well be very beneficial for investors may create a level of uncertainty that drives issuers and investors away from Canadian capital markets.

[1] See *e.g. Report of the Attorney General's Committee on Securities Legislation in Ontario* (Toronto: Queen's Printer, 1965) [the "Kimber Report"] at para. 1.06. See also *Gregory & Co. Inc. v. Quebec Securities Commission* (1961), 28 D.L.R. (2d) 721 at 725, [1961] S.C.R. 584 at 588; *Gordon Capital Corp. v. Ontario (Securities Commission)* (1991), 1 Admin. L.R. (2d) 199 at 208 (Ont. Div. Ct.); and *Brosseau v. Alberta (Securities Commission)* (1989), 57 D.L.R. (4th) 458 (S.C.C.); *Pezim v. British Columbia (Superintendent of Brokers)*, [1994] 2 S.C.R. 557 at 592, 114 D.L.R. (4th) 385 at 406 (S.C.C.). See further International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation*, May 2003, at 5-6.

Part 4 of this paper examines the attributes of a competitive capital market. The paper will look at the role of securities regulation in promoting a competitive capital market in the context of five main areas of securities regulation: mandatory disclosure; insider trading; market manipulation; takeover bid regulation; and securities industry regulation. It will examine arguments in favour of regulation in each of these five areas and will link the arguments to the promotion of a competitive capital market. It will also review critiques of arguments in favour of regulation and note how securities regulation can also impede the development of a competitive capital market. Part 5 will examine mandatory disclosure. Part 6 will look at insider trading. Part 7 will consider market manipulation, Part 8, takeover bid regulation and Part 9, securities industry regulation. Part 10 will make some suggestions as to potential ways forward in terms of improving the competitiveness of capital markets in Canada.

4. <u>Attributes of a Competitive Capital Market</u>

Securities regulation also focuses on primary market trading in which securities are initially distributed to the public. However, there is a link between competitiveness in secondary market and competitiveness in the primary market. If securities prices are lower than they otherwise might be due to a lack of competitiveness in the secondary market, it will affect what investors are willing to pay for securities in the primary market since they may eventually want to sell the securities in the secondary market. Thus the attributes of a competitive capital market as it relates to securities regulation need to be present in both the primary and secondary markets. The attributes of a competitive capital market that are set out below are those that securities regulation is most likely to affect (either favourably or unfavourably). They include: confidence in the market; liquidity; information costs; timeliness of information; transactions costs; agency costs; and certainty of the performance of securities transactions.

i. Confidence in the Market (or Integrity of the Market)

One important attribute of a competitive capital market is "confidence in the market" (sometimes also referred to as "integrity of the market"). Confidence in the market is associated with the extent to which fraudulent or unethical practices, such as market manipulation or the dissemination of false (or misleading) information, are controlled. As the Special Committee of the TSX put it,[2]

> "if the public perceives that trading in the market is open to manipulation through the dissemination of false information or deceptive trading practices, that insiders consistently are able to take advantage of their special knowledge or access to the market or that the market systematically discriminates against one group of investors over another, they will lose confidence in the market's integrity. Once this confidence is lost, the public's willingness to invest savings in the market will quickly erode".

Confidence in the market will be affected by the perception of fairness between investors. This will depend on the extent to which investors operate under the same rules and conditions such that no individual or group of participants has persistent advantages over others in terms of access to the marketplace, priority of execution of trades or the receipt of market information.

[2] TSE Special Committee Report, *Market Fragmentation: Responding to the Challenge*, at 25.

ii. Liquidity

Another important attribute of a competitive capital market is "liquidity". The liquidity of a capital market has to do with the market's capacity to absorb buy and sell orders for securities at or near the last sale price of a particular security.[3] Investors value the ability to be able to sell securities they hold reasonably quickly so that they can shift their investments or access funds they have invested in securities for other purposes. They also value having some reasonable certainty that they can sell at or near the last quoted price for the security.[4] Investors will thus pay more for securities that provide greater liquidity.

iii. Information Costs

Information is valuable in all markets for consumers to assess whether a particular product will meet their needs and to determine whether they are getting the best possible price for the product. Information about product prices and the costs of inputs will assist producers in determining the quantity of the product they should produce. Information is similarly important in securities markets. It is important for investors to determine the value of the securities. Investors need information to predict the potential future cash flows a security will generate and to assess the relevant risk associated with the security in order to determine a minimum acceptable level of return on the security. Issuers, with the assistance of investment bankers, need to be able assess what prices securities can be sold for. This allows issuers to determine the required rate of return for business projects they are considering investing in, thus allowing them to determine whether they should proceed with potential investment projects and raise funds from the public to invest in those projects. More information for investors and issuers should allow them to make better decisions, however it may not always lead to better decisions. This may occur, for instance, where too much information leads to information overload.[5] Excessive information may increase the costs of identifying relevant information and even lead to poorer decision-making.[6]

The amount of information gathered and assessed by investors and issuers will depend on the cost of the information. If the cost of information can be reduced, investors will acquire and assess more of it and thereby make better decisions. Investors will need to be compensated for the costs they incur in gathering and assessing information, and they will tend to adjust what they will pay for securities to build in this

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[3] *Ibid.*, at 17.
[4] *Ibid.*
[5] See further, *infra* notes 81 to 82 and the accompanying text.
[6] *Ibid.*

compensation. Costs incurred by issuers in providing information to investors will reduce the assets or potential future cash flows to investors and thus reduce the value of the issuer's securities. These costs include not only the fees associated with preparation and filing information, but also the cost of the issuer's staff to devote time to the preparation of these materials.

A market that can reduce the cost of information will tend to increase the value of securities in the market and thereby make the market more competitive. Thus, an important attribute of a competitive capital market is the extent to which it minimizes information costs.

iv. Timeliness of Information

The timeliness of information is also important to the competitiveness of a capital market. Information that would affect the value of an issuer's securities should be available to investors as soon as possible. Even assuming the market is efficient enough to cause securities prices to track their underlying values, to the extent information is delayed there will be a period during which securities prices will not track their underlying values. Inaccurate securities prices can impact the allocation of resources in several ways.[7] In particular, it may cause a misallocation of financial resources where issuers are in the process of raising additional capital.

A delay in the general availability of information creates the potential for some investors to have better access to information than others. Investors with better access to information may make gains at the expense of other investors. Other investors may then discount prices they are willing to pay for securities to compensate for these potential losses to investors who have better access to information.[8]

The cost of information may affect the timeliness of disclosure, but other factors may have an effect as well. There may, for instance, be an incentive for those who have early access to information to delay its disclosure so that they can profit on the information by trading in the securities before the information is disclosed.[9] An important attribute of a competitive capital market will thus be the speed with which information relevant to the value of securities is made available to the market.

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[7] See *infra* Part 5. ii. c).
[8] See *infra* Part 6. i.
[9] See the discussion of information hoarding *infra* note 106.

v. Transactions Costs

Another key attribute of a competitive capital market is the cost of making transactions. In the primary market, from the issuer's side, it involves the cost of distributing the securities. This can include the costs of fees such as underwriting fees, legal fees, and printing fees. It also includes the costs of the time staff of the issuer need to devote to the issuance. In the context of a distribution requiring a prospectus, this involves the time the staff spends preparing the prospectus. For investors, it includes the cost of effecting the transaction which may be reflected in the brokerage fees the investor pays. In the secondary market, the transactions costs to the issuer include the cost of compliance with requirements to maintain a listing and the costs associated with continuous disclosure requirements under securities laws.[10] A capital market will be more competitive to the extent it reduces transactions costs.

vi. Agency Costs

"Agency costs" are costs that arise where the interests of the management of an issuer of securities and those of investors are not well-aligned.[11] The value of securities to investors will be reduced where management has an incentive to either be less diligent or careful than they should be or engage in transactions where they may have a conflict of interest and therefore may have an incentive to put their interests ahead of investors. A capital market that minimizes agency costs will be more competitive.

vii. Certainty of Securities Transaction Performance

Investors need to be confident that the trades or other transactions they enter into in the securities market will be performed.[12] If there is no system in place to provide this assurance, investors will have to incur costs (information costs) to determine whether the parties they are dealing with in the particular transaction are competent to perform the transaction and are sufficiently creditworthy to compensate them in the event of non-performance. Investors will only incur costs to assess this to the extent that the marginal benefits in terms of reduced risk of non-performance outweigh the marginal costs of the assessment. There will be some residual risk of non-performance. Investors will want compensation for

[10] It would also include the added costs of dealing with public investors.
[11] See the discussion of "agency costs" in John Eatwell, Murray Milgate & Peter Newman, *The New Palgrave Dictionary of Economics* (London: Macmillan Press, 1987) [*Palgrave*] Vol. 1, at 39.
[12] This is dealt with in the TSE Special Committee Report on market fragmentation, *supra* note 2, at 24-25 under the rubric of the "integrity of the credit ring".

the information costs associated with assessing the risk of non-performance and for the residual risk of non-performance. They will need to discount the prices they pay for securities to build this compensation into their investments. This will increase required rates of return for issuers, thereby reducing the number of investment projects they undertake. A capital market will be more competitive to the extent that it reduces the information costs of assessing the risk of non-performance of securities transactions and the residual risk of non-performance.

5. Mandatory Disclosure

Securities laws in many jurisdictions around the world have specific requirements for the disclosure of information by issuers when securities are distributed to the investing public, together with requirements to keep disclosure up-to-date in support of subsequent trading of the issuer's securities. Since the disclosure is required it is often referred to as "mandatory disclosure". This part looks at the role mandatory disclosure may play in promoting a competitive capital market.

The primary argument for these disclosure requirements fits the notion of "confidence in the market" described in Part 4, above, particularly as it relates to the disclosure of false or misleading information. Disclosure requirements may also serve as a means of reducing information costs and possibly also as a means of reducing agency costs. Section I, below, notes the primary argument for the role of mandatory disclosure in improving the integrity of the marketplace. Section ii examines an argument that questions the need to mandate disclosure to improve the integrity of the marketplace. Section ii also notes criticisms of this argument and responses that have been made to those criticisms. Section iii examines the effect of mandatory disclosure on information costs and transactions costs, and Section iv notes some reform proposals that have been made.

i. The Role of Mandatory Disclosure in Improving Confidence in the Market

a) The Primary Market

Why is mandatory disclosure considered necessary? The concern, it is said, that arises on the distribution of securities (the "primary market") is that, were it not for such disclosure requirements, some issuers may take advantage of investors. Issuers and their promoters will have access to information investors don't have. This asymmetry of information may allow them to mislead investors by giving them an overly favourable picture of the potential returns and risks associated with the securities, thereby causing investors to pay more for the securities than they are worth. This might be done by making false or inaccurate disclosures of existing facts, overly optimistic projections of future cash flows or by failing, perhaps inadvertently, to disclose negative information that would cause investors to pay less for the securities.

In markets where there is an asymmetry of information that causes buyers to be unable to distinguish better quality products from poorer quality products, the producers of the poorer quality products tend to drive out the producers of the better quality products.[13] The buyers will not pay higher prices for the better quality products because they cannot be sure they are higher quality. If they paid the higher price, they may find themselves having paid the higher price for a lower quality product. To avoid this they discount the price that they will pay for the product so that they will not overpay. It may no longer be worthwhile to produce the higher quality products since the discounted price buyers are willing to pay may not cover the costs of producing the higher quality product. Production of the higher quality products thus tend to be driven out of the market by the lower quality products. This problem is known as "adverse selection".

The potential for an adverse selection problem has been described in the securities market context.[14] If investors cannot differentiate between the misleading disclosure of some issuers and the accurate disclosure of others, they will discount the prices they are willing to pay for all securities to protect themselves against the risk that they will overpay for securities in some cases.[15]

Securities regulation has often been said to be necessary to promote "confidence-in-the-market" or "integrity in the market". In the context of the disclosure of information concerning securities, mandatory disclosure might be said to promote confidence, or integrity, in the accuracy of disclosure. If securities regulation can reduce the frequency of misleading disclosures then it should reduce the degree to which

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[13] See George Ackerlof, "The Market for 'Lemons' Qualitative Uncertainty and the Market Mechanism" (1970) 84 Q.J. Econ. 488. On "adverse selection" see also Michael L. Katz & Harvey S. Rosen, *Microeconomics*, 2d ed. (Boston, Mass.: Irwin, 1994) at 578-79; and *Palgrave*, *supra* note 11, Vol. 1, at 32.

[14] See Frank H. Easterbrook & Daniel R. Fischel, "Mandatory Disclosure and the Protection of Investors" (1984) 70 Virginia L. Rev. 669 [Easterbrook & Fischel, "Protection of Investors"] at 673-74.

[15] Consider a simple (but, of course, overly simplistic) numerical example. Suppose an investor invests in 10 different issues of shares but experience suggests that 2 out 10 issues will be overpriced by 25% due to misleading information. Thus, for example, 2 out of the 10 issues of shares are really worth just $8 per share but the information disclosed misleadingly suggests they are worth $10 per share. Suppose that the prices on the remaining eight issues are based on accurate information and are really worth $10 per share. If the investor cannot distinguish which disclosures are misleading and which are not, then, in order not to overpay for the whole portfolio of 10 securities, the investor would have to discount the price of each issue by 4% and pay just $9.60 for each security. Buying a portfolio consisting of one share of each issue at $9.60 will cost $96 for a portfolio that is only worth $96 [i.e. (8 shares x $10) + (2 x $8) = $96].

Suppose further that each of the 10 issues involves investments in business projects that require $10,000 worth of funds. Also suppose that, taking into account the relevant risk associated with each of these 10 projects, the required rate of return is 10% per annum. All 10 issuers must sell 1,047 shares at $9.60 to raise the required funds. The businesses of the misleading disclosure issuers really only generate $800 in cash flows per annum (or 8% per annum on $10,000 worth of investment) while the businesses of the accurate disclosure issuers generate $1,000 per annum (or 10% per annum on $10,000 of investment). The misleading disclosure issuers will be providing a return on their shares of just 8%. Thus the cost of capital for the business engaged in by the misleading disclosure issuers, based on what they were able to sell the shares for, is just 8% while the cost of capital for the accurate disclosure issuers is 10%. If some of the misleading disclosure issuers are in the same business as the business as the accurate disclosure issuers then their overall costs will be less. They could sell their product for less and, in a competitive market, could out-compete, and thereby eventually drive out, the accurate disclosure issuers.

investors may be inclined to discount securities prices to adjust for the risk that the disclosures associated with some securities issues may be misleading. If securities regulation can improve the reliability of disclosure and reduce the discounting of prices, then the introduction of such regulation should attract investment until securities prices adjust to reflect the improved reliability of disclosure. This would, of course, require that the benefits of improved reliability of disclosure exceed the cost of compliance with the regulated disclosure regime. Subject to the costs of entering the regulated market and complying with post issuance regulatory requirements, foreign issuers making a choice between raising capital in a jurisdiction with such regulation and one without will be inclined to raise capital in the jurisdiction with such regulation since they can get higher prices for their securities in the jurisdiction with the more reliable disclosure.

b) The Secondary Market and its Link to the Primary Market

The same problem with reliability of disclosure could arise for secondary market trades after the initial public distribution of an issue of securities. If the information is not kept up to date in a reliable way, buyers of securities in the secondary market may be inclined to discount the price of the securities for much the same reason as they would on the distribution of securities. Sellers in the secondary market may increase their ask prices for securities for fear that they may undervalue some securities based on unreliable disclosure. The increased spread between the bid and asked prices may reduce liquidity, a key attribute of an efficient capital market. Liquidity is valuable to investors, and reduced liquidity may also cause investors to discount the price they are willing to pay for securities. Discounting of the prices of securities in the secondary market also affects the price investors would be willing to pay for securities in the primary market, since they need to take into consideration the price at which the securities can be sold in the secondary market. Lower liquidity in the secondary market will also make securities less valuable to investors in the primary market.[16] Thus problems with the reliability of disclosure to support secondary market trading will affect the primary market, and will thus affect investment with repercussions for economic growth.[17]

c) How Does Securities Regulation Make Disclosure More Reliable?

How does securities regulation in Canada attempt to provide for more accurate disclosure? In the context

[16] See the *Kimber Report*, *supra* note 1 at para. 1.12.
[17] For a review of literature on economic growth models, including the effect of increases in capital, see *e.g.* Kevin J. Stiroh, *Investment and Productivity Growth – A Survey from the Neoclassical and New Growth Perspectives* (Ottawa: Industry Canada, 2000) 3-15.

of a distribution of securities to the public it requires disclosure of information and requires that all material facts be disclosed. It then imposes consequences for misleading disclosures. The consequences include potential penal sanctions, administrative sanctions and civil sanctions. Penal sanctions involve fines for entities other than individuals involved in providing the misleading disclosure. Penal sanctions can also involve potential imprisonment for individuals responsible for the misleading disclosure. Administrative sanctions include: cease-trade orders either for particular securities or against particular persons; orders removing prospectus disclosure exemptions that can be very useful to an issuer; orders removing persons responsible for misleading disclosures from positions as directors or officers; and administrative penalties. Civil sanctions allow persons who have invested in securities for which there was misleading disclosure to seek rescission against the vendors of the securities or damages against persons responsible for the misleading disclosure. These potential consequences hopefully provide an incentive to issuers and persons responsible for disclosure to make reasonable efforts to avoid misleading disclosure.

ii. The Debate on the Role of Mandatory Disclosure

Regulatory responses to theoretical problems should, where possible, be supported by empirical evidence that confirms the existence and extent of the alleged problem. Regulatory responses should also, where possible, be followed up by empirical evidence assessing whether the regulatory response has been effective. There have, indeed, been several studies on the effects of mandatory disclosure.[18] The studies

[18] On the effects prospectus disclosure see G.J. Stigler, "Public Regulation of Securities Markets" (1964) 37 J. of Bus. 117; G.A. Jarrell, "The Economic Effects of Federal Regulation of the Market for New Security Issues" (1981) 24 J. of Law and Eco. 613; and C.J. Simon, "The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues" (1989) 79 Amer. Econ. Rev. 295. For comments on the Stigler study see I. Friend and E.S. Herman, "The S.E.C. Through a Glass Darkly" (1964) 37 J. of Bus. 382; and S. Robbins and W. Werner, "Professor Stigler Revisited" (1964) 37 J. of Bus. 406. On the effects of mandatory secondary market disclosure see G.J. Benston, "Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934" (1973) 63 Amer. Econ. Rev. 132. For a comment on the Benston study see I. Friend and R. Westerfield, "Required Disclosure and the Stock Market: Comment" (1975) 65 Am. Eco. Rev. 467. For more recent evidence on the effects of mandatory secondary market disclosure see Richard Frankel et al., "Discretionary Disclosure and External Financing" (1995) 70 Acct. Rev. 135 at 141 (showing a positive correlation between voluntary issuer disclosure and the issuance of securities); Maribeth Coller & Teri Lombardi Yohn, "Management Forecasts and Information Asymmetry: An Examination of Bid-Ask Spreads" (1997) 35 J. Acct Res. 181; (showing a positive correlation between information asymmetry (measured by the size of the bid-ask spread on the issuer's shares) and voluntary issuer disclosure); Christine A. Botosan, "Disclosure Level and the Cost of Equity Capital" (1997) 72 Acct. Rev. 323 at 344 and 346 (providing evidence that voluntary disclosure reduces an issuer's cost of capital).

generally did not provide support for mandatory disclosure.[19] The studies, however, arguably do not clearly resolve the question of whether mandatory disclosure increases the value of securities.[20]

a) The Costs of Mandatory Disclosure May Outweigh the Benefits

In light of the largely inconclusive studies, the need for mandatory disclosure has been reassessed. It has been argued that the confidence-in-the-market argument in support of mandatory disclosure does not stand up to scrutiny.[21] This challenge to the confidence-in-the-market argument accepts the potential "adverse selection" problem that may lead to overinvestment in low quality issues,[22] but notes that issuers have an incentive to address this problem in order to reduce investor discounting of the values of the issuer's securities. It also notes that there are steps that may be taken by issuers to address the problem. What issuers need to do is to take steps to convince investors of the accuracy of the information they provide and to convince investors that, as managers, they will have an incentive to act in the interests of

[19] The Stigler and Jarrell studies showed no statistically significant difference between pre-mandatory disclosure and post-mandatory disclosure post-issuance prices. They did find a reduction in risk but suggested that this was because the regulatory regime introduced by the Securities Act of 1933 in the U.S. discouraged riskier issues that, given the evidence on the prices noted above, would have been properly priced (i.e. would have been priced to give a return that compensated with the systematic risk on the securities). Simon had similar results for both seasoned and unseasoned issues on the New York Stock Exchange and seasoned issues on regional exchanges. Simon did, however, find that prices for pre-mandatory issues of unseasoned securities on regional exchanges fell post-issuance and that these post-issuance price decreases had a statistically significant reduction after the introduction of mandatory disclosure.

[20] The evidence provided in the Stigler, Jarrell and Simon articles referred to in note 18 above was based on the hypothesis that in the absence of mandatory prospectus disclosure, public offerings of securities were overpriced. Thus their tests examined whether the prices adjusted downwards in subsequent years as the market came to realize, on the basis of actual returns, that the securities were not worth what they were believed to be worth when they were issued. The only evidence of such decreases in price was that found by Simon for unseasoned issues on regional stock exchanges. Otherwise the studies showed no statistically significant post-issuance decreases in prices. It may have been, however, that the market was properly discounting the price on the issuance of securities based on their experiences with previous securities offerings. In other words, the information provided may have suggested a price of $10 but the market may have known from experience that the information provided that suggested a price of $10 was not entirely credible. The market may have thus discounted the price and paid only $8. That price may have been based on a market that had come to be dominated by less honest issuers, more honest issuers having been driven from the market as a result of adverse selection. It may be the case that mandatory prospectus disclosure improved the credibility of information, thus reducing the adverse selection problem, or provided other benefits (discussed in parts 5 ii c, d and e below), such that a security offered prior to mandatory prospectus disclosure would have sold for a properly priced $8 on issuance, but could sell for a properly priced $9 with the benefit of mandatory disclosure. In neither case would the issuances show a post-issuance drop in price since they were priced correctly on issuance (consistent with the results of the Stigler, Jarrell and Simon studies), but the mandatory prospectus disclosure issuance would be valued more highly than it would have been without mandatory prospectus disclosure.

[21] See *supra* note 14 Easterbrook & Fischel, "Protection of Investors". See also Frank H. Easterbrook & Daniel R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass.: Harvard Univ. Press, 1991) [Easterbrook & Fischel, *Economic Structure*] Chapter 11, "Mandatory Disclosure"; see also Beaver, "The Nature of Mandated Disclosure" Report of the Advisory Committee on Corporate Disclosure to the SEC, 95th Congress, 1st Sess. 618-56.

[22] *Ibid.* Easterbrook & Fischel, "Protection of Investors", at 673-74.

investors.[23] There are many steps they might take.[24] However, as each of these steps will involve costs, they will only be adopted to the point that the perceived marginal cost of such techniques just equals the perceived marginal gain from such techniques in terms of higher prices for the issuer's securities and a corresponding lower cost of capital.[25] Thus the argument that has been made is that mandatory disclosure, to the extent that it forces issuers to make disclosures they would not otherwise have made, may cause issuers to make disclosures for which the cost outweighs the benefits.[26] This would reduce the value of the issuer to the detriment of all security holders. The argument thus suggests that as far as disclosure is concerned, the appropriate type and amount of disclosure should be left to the market to determine.[27]

b) Early Responses Based on Other Alleged Market Failures

There have been several responses to this argument based on possible market failures other than the problem of adverse selection. The arguments generally point to differences between private incentives to disclose information or gather and assess information, and public benefits from the disclosure, gathering

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[23] *Ibid.* at 674-77, 682-84.

[24] To lend some credibility to the information they provide, issuers may get accountants to review financial disclosure and express an opinion as to its accuracy. The accountants will have a reputation to protect and will thus have an incentive to carefully review the financial disclosure. If the accountants do not carefully review the financial disclosure and it comes to be known that their opinions cannot be relied on, then issuers will be less likely to engage them because they can no longer credibly signal the accuracy of the issuer's disclosure to the market. Similarly, issuers will engage underwriters to market an issue of securities. The underwriters can also lend some credibility to an issuer's disclosure. The underwriter will have an incentive to check the issuer's disclosure in order to reduce their underwriting risk and to preserve their reputation. The underwriter's ability to market an issue of securities will be adversely affected if it develops a reputation for marketing securities that turn out to be losers. If an underwriter develops such a reputation, it will have difficulty offering competitive terms in underwriting engagements. Issuers may employ other techniques to signal the value of the securities by better aligning the interests of investors and managers. For instance, management of the issuer may own a substantial portion of the issuer's shares, so that their interests will be aligned with the interests of shareholders. This alignment of the interests of management and shareholders can provide some assurance to investors that management will not be inclined to take advantage of them. Similarly, management, whose careers may be closely tied to the continued existence of the issuer, can give some comfort to investors as to the value of the issuer's securities by causing the issuer to take on debt obligations that expose the issuer to a greater risk of bankruptcy. This exposes management to the risk of loss of their careers and thus gives them an incentive to redouble their efforts to pursue profits for the issuer and its investors. Management can also better align their interests with those of investors by adopting a high payout policy. This forces them to go to the capital market to raise new capital on a regular basis. It thus discourages management from acting against security holder interests because they will have to keep security prices high to raise new capital on favourable terms. See Easterbrook & Fischel, "Protection of Investors", *supra* note 14 at 675.

[25] *Ibid.* Easterbrook & Fischel, "Protection of Investors", at 684. See also Douglas W. Diamond, "Optional Release of Information by Firms" (1985) 40 J. Fin. 1071.

[26] See Easterbrook & Fischel, "Protection of Investors", *supra* note 14 at 682-85.

[27] *Ibid.* at 684-85. This line of argument is discussed in D.J. Schulte, "The Debatable Case for Securities Disclosure Regulation" [1988] J. of Corp. Law 535; N. Wolfson, "A Critique of the Securities and Exchange Commission" [1981] Emory Law J. 119. Homer Kripke, "A Search for a Meaningful Securities Disclosure Policy" [1975] Bus. Lawyer 292.

and assessment of information.[28] Issuers, for instance, may not be inclined to disclose information that helps investors value the securities of other issuers (perhaps, for instance, those in the same industry), or that assists their competitors, even though such disclosure may benefit investors.[29] Mandatory disclosure could then be justified as an attempt to provide cost-justified disclosure to investors that would not otherwise be provided. Securities information has also been said to have a "public good" quality[30] since once it is given to a user it will seldom be confined to that user.[31] Securities analysts therefore can't obtain the full economic value of their discoveries of information and will engage in less information gathering and verification.[32] Mandatory disclosure thus may serve to reduce the market professional's marginal cost of acquiring and verifying information, and thereby increases the amount of information gathering and assessment they will engage in.[33] There may also be a "race for the prize" problem in having many investors and analysts incur costs many times over, gathering the same information. Mandatory disclosure might then serve as a means of reducing the information costs by forcing issuers to incur the cost of providing the information (which the issuer may well be able to do at lower cost), and

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[28] See, e.g., John C. Coffee, Jr., "Market Failure and the Economic Case for a Mandatory Disclosure System" (1984) 70 Virg. L. Rev. 717.

[29] Indeed, issuers may be inclined to hold out on providing some forms of disclosure in the hope that other issuers will do it for them. See Easterbrook and Fischel, "Protection of Investors", *supra* note 14 at 685-87. See also Merritt B. Fox, "Retaining Mandatory Disclosure: Why Issuer Choice is not Investor Empowerment" (1999) 85 Virginia L. Rev. 1243 at 1345-46. Easterbrook and Fischel, however, note that mandatory disclosure is just one means of dealing with the problem. Markets, they suggest, can also devise ingenious solutions to problems of information (at 687). See also the discussion in Schulte, *supra* note 27, at 538-39. See also Fox, *ibid.* at 1363-68, noting that it can also assist in identifying managerial shirking or inefficiencies in other issuers. It has, however, also been argued that there may be an incentive for issuers to produce too much information — see M.J. Fishman and K.M. Hagerty, "Disclosure Decisions by Firms and the Competition for Price Efficiency" (1989) 44 J. of Fin. 633.

[30] A "public good" is one in which the producer of the good can not exclude persons from enjoying the benefit of the good and the use of the good by one person does not diminish it usefulness to other persons. The producer of the good will thus not be able to charge for the good (since persons cannot be excluded from enjoyment of it). In other words, persons can "free-ride" on the efforts of the producer of the public good and it will not be worthwhile for anyone to produce that particular good. The good will not be produced even though the benefits that others could derive from the use of the public good would outweigh the costs of producing the public good. See Milton H. Spencer, *Contemporary Economics*, 6th ed. (New York: Worth Publishers, 1986) at 68 and D-46. See also Campbell R. McConnell, Stanley L. Bruce & William H. Pope, *Economics*, 5th Cdn. ed. (Toronto: McGraw-Hill Ryerson, 1990) 194-96. See also Coffee, *supra* note 28, at 725, n. 23

[31] See Coffee, *supra* note 28, at 725 stating that securities information displays the key characteristic of a public good (non-excludability – see *supra* note 26) and thus,

> "It seldom can be confined to a single user because many people have a motive to leak it. When the corporate insider tips a friend of a material impending development, the information does not stop with the tippee, but tends to be passed on. In fact, it is generally in the tippee's interest, once he has traded, to inform others to create excitement and induce a market upswing. Otherwise, the tippee achieves only the dubious victory of owning an undervalued security, …"

It does, however, seem possible that a person with advance information can benefit from the information without leaking it by simply waiting until it becomes publicly disclosed. The tipping approach to obtaining a benefit from the information would, of course, under the current regulatory regime in Canada, be a violation of provincial securities act and federal *Criminal Code* prohibitions of informing others of inside information.

[32] *Ibid.* Coffee at 723-33.

[33] *Ibid.* at 729.

make it available to all investors.[34]

There are potential market responses for each of these alleged market failures. For instance, stock exchanges can address the problem of issuers producing too little information. Issuers have an incentive to join stock exchanges because they can increase the value of an issuer's securities and thereby reduce its cost of capital. A stock exchange can do this primarily by providing liquidity and, in part, by providing investors with a signal of the viability and credibility of the issuer. The exchange provides liquidity by bringing buyers and sellers together, but also often by having market specialists who stand by to buy or sell particular securities - ensuring they can be bought or sold for a price close to the price of last reported trade. The exchange can accept or not accept issuers for listing, controlling which issuers will be listed on the exchange. The exchange can thus develop a reputation for controlling against weaker issuers. A listing on the exchange can then operate as a signal to investors of the quality of an issuer depending on the reputation developed by the exchange. Stock exchanges, whose business depends on their reputation, can, and usually do, have disclosure rules that can address the problem of an issuer's incentive to produce too little information.[35] Were it not for the disclosure rules provided by securities regulation, exchanges might well have their own disclosure requirements for issuers that could overcome the problem that issuers may have less-than-optimal incentives to disclose. If necessary, disclosure requirements set by an exchange could require issuers to produce needed information once and thereby avoid numerous investors having to repeatedly incur costs to produce the same information over and over again.

The problem of excessive costs caused by investors incurring duplicating efforts in gathering the same information may be overstated, because trades by investors on the information gathered affect the price of the security and thereby reduce the profits others might obtain by gathering the same information. Further, by trading based on the information they have gathered, investors, to some extent, reveal the information they have gathered, thus relieving other investors of the need to incur the costs of gathering that information.[36] The issuer has an incentive to avoid investors incurring the same cost of producing the information repeatedly. Investors will want to be compensated for their costs in gathering information. They will reduce the price they pay for a security so that the returns on the security compensate them for their information costs, as well as give them a reasonable return on the funds they have invested. An

[34] See Coffee, *supra* note 28 at 733. The two claims that market failures 1) cause too little information to be produced, and 2) cause too much information production activity, appear inconsistent. Coffee says (at 734) there is no contradiction in saying that, "[t]he first problem arises because too few companies are followed or are researched inadequately; the second because investigations by one analyst are duplicated by another".
[35] Easterbrook and Fischel, "Protection of Investors", *supra* note 14 at 689-90.
[36] *Ibid.* at 689.

issuer can reduce this basis for investor discounting of prices on the issuer's securities by reducing the information costs investors incur. They can do this by incurring the cost just once and providing that information to investors. They may need to signal the credibility of this information, but information intermediaries such as underwriters, accountants, engineers, or rating organizations can help with this. These intermediaries have an incentive, albeit perhaps imperfect, to take care in verifying the information since their business will depend on their reputation and their reputation will be adversely affected if the information is subsequently found to be false or misleading.[37]

c) Societal Benefits of Mandatory Disclosure Due to Improved Securities Price Accuracy and Securities Market Liquidity

A more recent argument in favour of mandatory disclosure is that it can improve securities price accuracy and increase market liquidity by reducing the cost to informed investors of gathering information.[38] The reduced cost of information allows them to gather more information and thereby make more accurate estimates of securities values. Trades based on this better information should produce more accurate securities prices (i.e. securities prices that better reflect the underlying values of the securities). More accurate securities prices will also attract more informed trading by reducing risk that may otherwise deter some trading.[39] More accurate securities prices can reduce losses to society in several ways.[40] Inaccurate securities prices can cause a misallocation of investment funds to productive activities.[41] They can reduce securities market liquidity.[42] They can increase the risk investors are exposed to.[43] They may

[37] *Ibid.* at 687-89.
[38] Informed traders are persons who trade securities making use of available information.
[39] See Nicholas L. Georgakopoulos, "Why Should Disclosure Rules Subsidize Informed Traders?" (1996) 16 Int'l Rev. of Law and Econ. 417, at 423-24.
[40] See Marcel Kahan, "Securities Laws and the Social Costs of 'Inaccurate' Stock Prices" (1992) 41 Duke Law J. 977.
[41] Absent external costs and benefits, a profitable investment project for an issuer of securities will also be one that produces a net gain to society. If a security is overpriced, the issuer may raise capital for a project that would be unprofitable. Absent external benefits to society that would not accrue to the issuer, an unprofitable project for the issuer will be one that results in a net social loss to society. Similarly, if a security is underpriced the issuer may not pursue what would otherwise be a profitable investment project thereby forgoing a potential net gain to society. See *ibid*. Kahan, at 1005-17. See also Fox, *supra* note 29 at 1358-63.
[42] Kahan argues that inaccurate stock prices can make investors reluctant to trade stock and thereby reduce the liquidity of the market. This can result in social losses because reduced volumes of trading can result in higher transactions costs of trading and because such higher transactions costs may discourage otherwise optimal adjustments in investment portfolios. *Ibid.*, Kahan, at 1017-25.
[43] To risk-averse investors, risk is a cost. It is something they would rather avoid. Thus increases in risk increase costs to investors, which constitutes a social loss. Inaccuracies in security prices increase the volatility of security prices and thereby increase risk. *Ibid.*, Kahan, at 1025-28. See also Fox, *supra* note 29 at 1357-58.

also produce macroeconomic shocks,[44] impede the proper operation of the market for corporate control,[45] produce inefficient terms in corporate charters,[46] and may result in poor decisions by managers as to what investment projects should be pursued.[47]

While some securities price inaccuracies may persist in the market with resulting social losses, it does not necessarily mean that mandatory disclosure is the solution. The question is whether mandatory disclosure can reduce the inaccuracies in a way that results in gains that outweigh the costs of mandatory disclosure. The securities price inaccuracy argument in favour of mandatory disclosure is that by subsidizing the information gathering efforts of informed short-term securities traders, mandatory disclosure reduces securities price inaccuracies and increases securities market liquidity, resulting in gains that outweigh the costs of mandatory disclosure.[48] The argument is that issuers would not voluntarily provide this type of disclosure because, although it would benefit short-term informed traders, it would not benefit longer-term investors. Longer-term investors would not reap sufficient gains from trading on increased disclosures to compensate for the added cost of increased disclosure. Because it would not benefit these longer-term investors, they would not support the expenditure of an issuer's funds on the disclosure of information that would assist informed short-term traders in assessing the value of the issuer's securities. It is argued that longer-term investors will tend to hold a greater portion of the voting securities of an issuer and will therefore dominate in decisions on disclosure by issuers. Issuers will thus choose not to make some forms of disclosure even where disclosure would result in a net social gain from producing more accurate securities prices.[49] Mandatory disclosure then, in effect, forces longer-term investors to

[44] For example, a sudden substantial decrease in stock prices can cause investors to have significant perceived reductions in personal wealth. This can affect their consumer spending decisions, reducing the aggregate level of consumer spending and thus lowering the overall level of economic growth or causing a recession. *Ibid.*, Kahan, at 1034-35.

[45] A change in who controls a corporation, or other issuer of securities, can be beneficial when it results in an increase in the value of the corporation's assets by deploying them in valuable uses or more effectively managing them. See the discussion in Part 11. If the stock of an issuer is undervalued it can encourage a take-over that does not result in any increase in the value of the corporation's assets. This is discussed in more detail in Part 11. Similarly, if the stock of an issuer is overvalued it can deter a change in control that might in fact result in an increase in the value of the corporation's assets. *Ibid.*, Kahan, at 1034-37. See also Fox *supra* note 29 at 1363-68.

[46] If the market is unable to accurately assess the value of some beneficial corporate charter provisions at the time of an initial public offering of a security, then the promoter may not have an incentive to put in the beneficial corporate charter terms. Similarly, a promoter may have an incentive to put a term in the corporate charter that favours himself at the expense of investors if the market is unable to accurately assess the negative effect of such a corporate charter term. *Ibid.*, Kahan, at 1038-39.

[47] Inaccurate securities prices can also cause corporate managers to have a mistaken impression of the required rate of return for investment projects they are considering. This may cause them to accept investment projects that result in a net social loss, or possibly, reject investment projects that would result in a social gain. *Ibid.*, Kahan, at 1039-40; Fox *supra* note 29 at 1358-63.

[48] Georgakopoulos, *supra* note 39 at 425-27.

[49] *Ibid.*

subsidize disclosure that increases trading by informed short-term traders, resulting in more accurate securities prices and the associated social gains.[50]

The resolution of the collective action problem for the issuer's securities holders, noted above, might not require statutorily imposed mandatory disclosure. A stock exchange could serve to overcome this collective action problem. As noted above, securities holders can benefit from having the issuer's securities listed on a stock exchange or other securities exchange. Issuers thus have an incentive to list their securities on an exchange and the exchange may well overcome this alleged collective action problem by requiring certain forms of disclosure in return for giving the issuer the right to have its securities listed on the exchange.[51]

d) Mandatory Disclosure as a Means of Standardizing Information Presentation

It might also be argued that mandatory disclosure is beneficial to the extent it standardizes the presentation of information.[52] Standardization in the presentation of information can reduce the cost to securities market analysts of gathering information and in comparing information between securities issuers. The reduced information costs will permit more gathering and assessment of information, and better information comparisons, thereby allowing more accurate assessments of securities prices.

Securities exchanges may be able to provide a substantial degree of standardization. In return for the privilege of listing securities on an exchange, issuers can be subjected to substantial amounts of standardized disclosure with formats of presentation that would facilitate comparisons to other issuers. An exchange that has a large number of issuers listed on it would allow for a wide range of comparisons. Two or more exchanges might find it worthwhile to co-operate in the standardization of disclosure and the presentation of disclosure, to increase the number of issuers disclosing similar information in similar formats and thereby facilitating comparisons. It is thus doubtful that there would be much residual benefit, in terms of information cost savings, to a statutorily imposed form of mandatory disclosure.

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[50] *Ibid.* at 423-24.

[51] See Easterbrook & Fischel, *Economic Structure*, *supra* note 21 at 295, noting that before statutory mandatory disclosure requirements were introduced in U.S. federal law, the New York Stock Exchange had an elaborate program requiring detailed disclosure at the time securities were issued as well as required annual disclosure.

[52] *Ibid.* at 303-4. See also Easterbrook & Fischel, "Protection of Investors", *supra* note 14 at 686-87 and J. Azzi, "Disclosure in Prospectuses" (1991) 9 Co. and Sec. L.J. 205, at 215-16.

e) Credible Commitment Theory

For each of the market failure arguments noted in Part 5, ii - b), c) and d), above, there is a plausible argument that there are market mechanisms that could address the alleged market failure problem. There may, indeed, be no actual market failure if there are market mechanisms that can respond to the alleged problems. The extent to which these market mechanisms address the alleged problems is an empirical question. But even if the empirical evidence showed that these market mechanisms operate imperfectly, it does not mean that the appropriate response is regulation. Regulation can itself be imperfect. A regulatory response may, however, trump a market mechanism response where it has some advantage over market mechanisms.

It has been suggested more recently that the role of mandatory disclosure is to allow issuers to make a "credible commitment" concerning their disclosure.[53] This theory seems to fit with the idea of "confidence in the market" and the various manifestations of that concept set out in preceding parts of this report. It also points to an advantage that a regulatory response may have over a market mechanism response.

The theory begins with the premise that investment decisions have three general concerns. First, the investor has to be able to value the security when it is first offered. Second, the investor will worry about changes in the value of that investment over time, particularly if there is a controlling security holder or group of controlling security holders, who could make changes to the disadvantage of the investor. Third, the investor will be concerned that the securities can be sold later at a price that approximates the value of the securities.[54]

As to the first concern investors will want some assurance about the quality and credibility of the information that is provided when the securities are offered for sale. With respect to the second concern, the investor will want continuing information to be provided to allow them to monitor the behaviour of managers or controlling security holders. In particular, it may be important that managers be committed to disclosing not just good news but also bad news that they would otherwise be disinclined to disclose. With respect to the third concern, investors will want continuing information to be provided to allow secondary market investors to value the securities so that they will be willing to buy the securities.[55]

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[53] Edward Rock, "Securities Regulation as Lobster Trap: A Credible Commitment Theory of Mandatory Disclosure" (2002) 23 Cardozo L. Rev. 675.
[54] *Ibid.* at 684.
[55] *Ibid.* at 684-85.

The issuer needs to be able to provide investors with a credible commitment to providing this ongoing disclosure. At the same time, there may need to be changes to the nature of the disclosure over time. How can one allow changes over time without leaving the door open to the issuer to make changes that are not in the interests of the existing investors? One might conceive of a contract to achieve this, but it would be a very complex contract and would be limited to the kinds of enforcement mechanisms available for breach of contract (i.e. the usual contract remedy of damages or the more exceptional contract remedy of specific performance). Securities laws allow issuers to make a credible commitment by making it easy for issuers to choose to be bound by the securities laws, but, once they have done so, making it difficult for issuers to choose to no longer be bound by securities laws. Securities laws provide for disclosure on the initial offering of securities as well as ongoing disclosure, and allow for enforcement mechanisms that can include penal sanctions and administrative sanctions in addition to private actions for damages and specific performance. These enforcement mechanisms back up the quality of disclosure since misleading disclosures will lead to sanctions. Changes in required disclosures are taken out of the hands of the issuers and put in the hands of the regulators, thereby preventing issuers from making changes that are contrary to the interests of existing security holders.[56]

It was suggested in the previous paragraph that issuers can choose to be bound by securities laws. How do they do this? They do this by choosing to "go public". Once they have gone public they must comply with the securities laws until they "go private". Going private cannot be done by a mere vote of security holders; to go private, the issuer of the securities must buy back the securities. While this is not impossible, it can be difficult and expensive. Thus once the issuer chooses to go public, thereby triggering the requirement to comply with securities laws, it will be difficult for it to choose to no longer comply with those laws: in going public, an issuer, in effect, commits itself to long-term compliance with securities laws.[57] In the international context, an issuer also makes a choice about the securities laws it will comply with. The issuer can choose to issue securities in other jurisdictions but each time it does so it must comply with that jurisdiction's securities laws. For instance, an issuer that has issued securities in Canada may later choose to issue securities outside of Canada, in the United States, for example, thereby requiring it to comply with U.S. securities laws. Alternatively, the Canadian issuer might instead choose to issue securities in Britain, thereby committing itself to British securities laws and not to U.S. securities laws by not issuing securities in the United States.[58]

[56] *Ibid.* at 686-91, 696-700.
[57] *Ibid.*
[58] *Ibid.* at 691-96.

f) Summary of the Debate on Mandatory Disclosure

The debate over the need for mandatory disclosure in securities regulation follows a pattern of market failure problems advanced as the reason for mandatory disclosure, with responses that the market itself may be able to address these problems. The key issue in the choice between accepting market solutions and imposing a regulatory solution is whether one approach has an advantage over the other. Regulatory solutions may themselves have failure problems in the public choice process in which rent-seeking lobbying[59] can lead to regulatory responses that are not consistent with the broader interests of society. In the capital market context it may lead to regulatory responses that are not consistent with promoting a competitive capital market.

Thus the question with respect to mandatory disclosure, as noted in Section ii e), above, is whether it has an advantage over market solutions in promoting a competitive capital market. Mandatory disclosure may have an advantage over market solutions. The credible commitment theory noted in Section ii e) above suggests an advantage over market solutions, including reliance on stock exchanges, primarily because of the enforcement mechanisms that can be employed in a regulatory system and because once an issuer has decided to go public, it is hard to reverse the decision (thereby committing the issuer to continuing disclosure according to securities law requirements).

iii. Mandatory Disclosure Implications for Transactions Costs and Information Costs

While mandatory disclosure can address market failure problems in a way that market solutions may not be able to, it can also impede the development of a competitive capital market. It can easily be carried to the point that it imposes costs of compliance, thereby increasing the transactions costs of public issuances of securities, to an extent that outweighs the benefits it may otherwise provide. It can also raise information costs rather than lower them if excessive amounts of information disclosure are required.

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[59] "Rent-seeking refers to activities aimed at obtaining or keeping economic rents." See Katz & Rosen, *supra* note 13, at 658. "Economic rent" is "what the supplier of a good or service gets paid above and beyond what is needed to induce it to supply the output." *Ibid.*, at 364. Thus rent-seeking lobbying involves lobbying efforts to obtain profits over and above those that could be obtained in a competitive market (since the amount obtained in a competitive market is what the supplier of a good or service would need to induce it to supply the output). In addition to the waste of resources in the lobbying activity itself, economic rents result in transfers of wealth and potentially significant net social welfare losses. See the discussion in *Palgrave*, *supra* note 11, Vol. 4, at 147.

a) Effect on Transactions Costs

The costs of compliance will increase with the complexity of the requirements. There is the cost of lawyers becoming familiar with all the provisions in order to properly advise their clients, a cost that increases with the complexity of the regulatory requirements. If the disclosure requirements are changed frequently, compliance costs will increase since lawyers and others will need to learn and adjust to the new requirements. The costs of administering and enforcing the disclosure requirements must also be taken into consideration. As disclosure requirements become more complex and detailed, the administrative costs of monitoring for compliance will increase since there will be more details that need to be checked. The multi-jurisdictional approach to securities regulation in Canada also adds, perhaps unnecessarily, to these costs. All these costs increase the transactions costs of making public offerings of securities.

The credibility of mandatory disclosure on the distribution of securities under a prospectus is backed up by statutory civil liability for misrepresentations. The credibility of continuous disclosure requirements is backed up by common law civil liability and, more recently, in Ontario by statutory civil liability. While potential civil liability may lend credibility to information disclosure (thereby increasing confidence in the market and reducing information costs that might otherwise be incurred in verifying information that has been disclosed), it can increase the cost of disclosure. Directors and officers of corporations, or persons in similar positions in non-corporate issuers, who may be subject to personal liability,[60] may be inclined to engage in excessive efforts to protect themselves. Since they are spending issuer funds in protecting themselves there may be a tendency to take care in the preparation of disclosure to a degree that is far beyond what is in the interests of investors.[61] Insurance and indemnification may address this problem but may do so incompletely.[62] If liability is imposed too readily, the costs incurred may outweigh the benefits to investors, resulting in a net reduction in the value of securities.

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[60] Directors and officers would not normally be liable for corporate acts unless the court pierces the corporate veil. Courts only pierce the corporate veil in exceptional circumstances.
[61] On the potential for excessive deterrence see, e.g., Ronald J. Daniels & Susan M. Hutton, "The Capricious Cushion: The Implications of the Directors' and Officers' Insurance Liability Crisis in Canadian Corporate Governance" (1993) 22 C.B.L.J. 182 ["Capricious Cushion"]. See also Ronald J. Daniels, "Must Boards go Overboard? An Economic Analysis of the Effects of Burgeoning Statutory Liability on the Role of Directors in Corporate Governance" (1995) 24 C.B.L.J. 229.
[62] *Ibid.*, "Capricious Cushion", at 189-98, 225-28.

b) Effect on Information Costs

While mandatory disclosure provides information to investors in a way that makes it more reliable, it can, if carried too far, overwhelm investors with excessive amounts of information. The truly significant information may be hard to access in the midst of reams of relatively unimportant information. It has also been suggested, on the basis of evidence from behavioural psychology, that in addition to increasing the cost of finding relevant information, information overload may negatively affect the ability of investors to assess the relevant information they do manage to tease out of excessive amounts of information.[63] Overall, excessive disclosure requirements may actually increase information costs instead of minimizing them as a competitive capital market should.

iv. Recent Mandatory Disclosure Reform Proposals

There have been various reform proposals in recent years concerning mandatory disclosure.[64] These are briefly reviewed below.

a) Agency Cost Emphasis, Not Accuracy Enhancement

It has been suggested that securities laws should focus on "agency cost" problems and abandon disclosure that focuses on enhancing the accuracy of securities prices.[65] Mandatory disclosure, it is argued, should be directed primarily toward reducing the agency costs that arise due to the risk that the promoters of a business may try to divert investor funds to themselves, their family, friends or business associates. Investors, aware of this potential problem, would:

> "want to know how much of the funds being raised in the offering will go toward the payment of commissions, fees, and similar expenses; whether the persons to whom those amounts are being paid have any pre-existing relationship with the promoter or directors that might call into question whether the terms reflect arm's length bargaining; and, generally, what other financial interests the promoter,

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[63] See Troy A. Paredes, "Blinded by the light: Information Overload and its Consequences for Securities Regulation" (2003) 81 Wash. U.L.Q. 417. See further *infra* Part 5, iv, e).
[64] Some proposals made prior to the 1990s are briefly reviewed in Mark Gillen, *Securities Regulation in Canada*, 2d ed. (Toronto: Carswell, 1998) at 303-06.
[65] See Paul G. Mahoney, "Mandatory Disclosure as a Solution to Agency Problems" (1995) Univ. of Chicago L.R. 1047.

directors, or persons connected with them have in the offering."[66]

Because agency-related information is readily available to the promoter and is limited in scope, it should not be costly for promoters to produce. Agency information, it is suggested, can also be set out with reasonable precision. Information that is relevant to enhancing securities price accuracy is, on the other hand, likely to be immensely wide in scope. It can be difficult to assess in advance what types of information will be relevant to determining the value of a particular security, and what is relevant may vary widely from one type of issuer to another. Consequently, mandatory disclosure requirements that attempt to accommodate a wide range of issuers are likely to lead to disclosure of a great deal of irrelevant information. The argument also suggests that many types of information that might be relevant to investors in assessing securities values may not be particularly relevant to managers for the purpose of managing the business. Thus information that may be relevant to investors in valuing securities may include information that will not be readily available to managers and will have to be produced at potentially substantial additional cost.[67]

The idea in this argument fits well with improving the competitiveness of a capital market. It seeks to reduce compliance costs (and therefore transactions costs) by reducing the amount of information issuers need to disclose and focusing on the kind of information that is likely to be readily available to them (and thus less costly to disclose). Another key to the argument is that the information that is most important to investors is the agency cost information that issuers can produce at lower cost than other information that relates more generally to the valuing of securities. Thus the argument, if it has merit, seeks to reduce compliance costs to the issuer while not significantly reducing the value of mandated disclosure to investors. It would also, in theory, reduce the size of the prospectus, thereby reducing potential information overload that can increase the cost of information.

Two difficulties with this argument are: 1) the difficulty of determining which information is "agency cost" information, and 2) the effect on the cost to investors of obtaining non-agency cost information that is needed to assess the value of an issuer's securities. One may be able to differentiate some forms of required disclosure as clearly related to agency costs, but as one goes through the list of disclosure items in a prospectus form it seems likely that there would be differences of opinion as to whether they are related to agency costs or not. Further, while non-agency cost information that is needed to better assess the value of securities may be more costly to an issuer to disclose than agency cost information, it may

[66] *Ibid.* at 1053.
[67] *Ibid.* at 1093-94.

nonetheless be overall less costly for the issuer to provide that information to investors - incurring the cost a single time - rather than to have numerous investors gather the information for themselves, each incurring the costs of gathering that same information over and over again.

b) Issuer Choice Proposals

The current approach to securities regulation in countries around the world is that if an issuer wants to distribute securities in a particular country, the issuer must comply with the securities laws of that country. In the late 1990s, various academics proposed an issuer-choice approach to securities regulation.[68] Under this approach the issuer would choose which jurisdiction's securities laws it would comply with and that set of laws would apply wherever it sold securities.

This seems, at first blush, a rather striking concept. The way it would work, for example, would be that an issuer issuing securities in Canada could choose to follow the securities laws of France rather than those of Canada. This would only extend to the disclosure requirements. It would not extend to, for instance, the regulation of securities industry participants such as brokers, underwriters or advisors.

While this concept is striking, it is not a concept unknown to the law or to international conflict of laws; for example, the law with respect to ship registration is governed by the law of the country in which the ship is registered. Another example that is close to the securities regulation context is that of corporate governance. Many jurisdictions around the world follow the "statutory domicile" rule concerning corporate governance (i.e., the law concerning the governance structure of the corporation is governed by the law of the jurisdiction in which it was incorporated). Thus, for instance, in a suit brought by a shareholder on behalf of the corporation against a director or officer of the corporation, the statutory domicile rule effectively says, "the terms under which the shareholder bought the shares and the terms under which the director or officer implicitly agreed to be governed were the terms by which they understood the corporation would be governed – i.e. in addition to the constating documents of the corporation (such as the articles or by-laws), the terms of the corporate statute under which the corporation was incorporated". One might make a similar argument in the context of securities laws. The issuer announced that it would be governed by the securities laws of France and so the investor understood that those would be the laws that would govern (even though the investor was resident in, and

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[68] See, e.g., Roberta Romano, "Empowering Investors: A Market Approach to Securities Regulation" (1998) 107 Yale L.J. 2361; Stephen J. Choi and Andrew T. Guzman, "Portable Reciprocity: Rethinking the International Reach of Securities Regulation" (1998) 71 S. Cal. L. Rev. 903.

acquired the securities in, some country other than France).

A variation on this approach would constrain issuer choice.[69] It would apply the securities laws of the jurisdiction in which the issuer was a "national". "Nationality" would be determined by looking to "an identifiable single country where its original entrepreneurial talent and the largest portion of its management and workers are concentrated."[70]

The concept behind allowing an issuer a relatively free choice of the securities laws that would apply to its distributions of securities is that jurisdictions would compete to produce the type of securities regulation that would be the most efficient with respect to making the securities more valuable. A similar argument has been made in the incorporation context. In the United States, where one can incorporate in any one of the fifty states, there is the curious phenomenon that when a corporation chooses to change its jurisdiction of incorporation (i.e. a "reincorporation" or, in terms of the expression used in many Canadian corporate statutes, a "continuance"), by far the most common choice of the new state of incorporation is Delaware.[71] Thus, in the competition between states to attract re-incorporations, Delaware is the clear winner. One argument is that Delaware is the winner because it has the better corporate law (the "race-to-the-top" theory).[72] A counterargument that is that Delaware is the winner because it has the type of law that allows corporate managements to best take advantage of investors (the "race-to-the-bottom" theory).[73]

Would such a competition in securities law be a "race to the top" or a "race to the bottom"? If the credible commitment theory discussed above[74] is correct, what would be the consequence of allowing issuers to make relatively easy changes to their choice of securities law jurisdiction? Would an issuer-choice approach require restrictions on the issuer's ability to change its choice of jurisdiction?

Another issuer-choice proposal that has been made is to allow the issuer to opt out of the securities laws

[69] See Merritt B. Fox, "The Political Economy of Statutory Reach: U.S. Disclosure Rules in a Globalizing Market for Securities" (1998) 97 Mich. L. Rev. 696
[70] *Ibid.* at 733.
[71] For a discussion of the Delaware phenomenon see *e.g.* Roberta Romano, *The Genius of American Corporate Law* (Washington: AEI Press, 1993) 14-51.
[72] On the race-to-the-top theory in the corporate law context see Ralph K. Winter, "State Law, Shareholder Protection, and the Theory of the Corporation" (1977) 6 J. of Legal Studies 251.
[73] On the race-to-the-bottom theory in the corporate law context see William L. Cary, "Federalism and Corporate Law: Reflections upon Delaware" (1974) 88 Yale L. J. 663.
[74] See in Part 5, ii, e).

of the jurisdiction in which it is distributing securities.[75] The way this would work in the context of Canada is that the issuer could simply say that it would not be complying with the applicable provincial securities acts or regulations. This approach would arguably put pressure on the government and the Canadian securities regulators to provide laws that were beneficial to issuers and investors alike by providing laws that raise the value of securities. Issuers would then *not* want to opt out of compliance with the laws.

Would all issuers simply opt out to avoid the costs of the regulation and to take advantage of unsuspecting investors? They might if securities markets were not efficient enough to distinguish between the value of securities of issuers operating under the securities regulatory regime and the value of securities of issuers that had opted out of the regulatory regime. Presumably, the way it would work is that some simple mechanism would be provided for determining whether issuers were subject to the regulatory regime. That would at least make it easy (i.e. low cost) for market participants to distinguish between issuers subject to the regulatory regime and those that were not. The difficult part would be determining the effect of the regulation on securities values. I suspect investors would be reluctant to invest in issuers that opted out of the securities regulatory regime. Such an opt-out approach might, I suspect, only witness opting out in the event that the securities regulatory regime was perceived to increase transactions costs to such a significant extent that it clearly wiped out any benefits in terms of confidence in the market. If that happened in the non-opt out regime (i.e. the current regime), it might be expected to lead to a shift by issuers and investors to foreign markets initially and, eventually, to strong lobbying to change the laws. The possible advantage then of the opt-out regime is that it might deter a drift towards securities value-reducing securities laws and otherwise put pressure on regulators sooner to correct securities laws that tended to reduce securities values.

c) Regulation by Stock Exchanges

It has also been argued that securities regulation should be left to securities exchanges.[76] In other words, the disclosure requirements would be determined by the requirements of the securities exchange on which an issuer chose to list its securities. There would be no securities law requirements created pursuant to statutes. There would be no securities commissions. The rules of the securities exchange would not be subject to government control.

[75] See Alan R. Palmiter, "Toward Disclosure Choice in Securities Offerings" [1999] Colum. Bus. L. Rev. 1.
[76] See Paul G. Mahoney, "The Exchanges as Regulator" (1997) 83 Virginia L. Rev. 1453 [Mahoney, "Exchange as Regulator"].

The issuer would have choice under this regime as well. It could choose which securities exchange, or exchanges, it wished to have its securities listed on. If it did not like the rules of a particular exchange, it could choose not to list its securities there. This would be similar to the issuer-choice proposals referred to above, in the sense that it would create a competition. However, the competition would be among securities exchanges rather than amongst governments of different jurisdictions passing securities law statutes together with the rules and policies created by securities commissions set up under such statutes. Regulation might then tend to be driven more by market forces and, if the market forces worked properly, lead to securities regulation that increases the value of securities.

Like the issuer-choice proposals above, would this lead to "race-to-the-bottom" or a "race-to-the-top"? This raises questions similar to the issuer-choice proposals, in terms of whether the market is efficient enough to make distinctions between the effects of different sets of securities exchange rules on the values of securities. While market participants may not be able to anticipate *ex ante* the effect of a particular set of rules of one exchange versus the effect of another's, they may be able to assess the effects of differing sets of rules over the longer term not so much by understanding the rules but by comparing, for instance, returns on investment for given levels of risk on the two exchanges. Whether the market is efficient enough to do this is a difficult empirical question.[77]

In terms of the credible commitment theory discussed above,[78] would a securities exchange be able to provide sufficient enforcement mechanisms to allow an issuer to make a credible commitment to the rules of the particular exchange? A securities exchange cannot provide for penal sanctions including fines and imprisonment. This would constrain the ability of a securities exchange to enforce its administrative sanctions. The main enforcement mechanism for a securities exchange is to delist the issuer's securities. Would such a sanction deter an issuer that wanted to shift its listing to another securities exchange that had different disclosure rules? If the answer to this question is "no", then it suggests that abandoning publicly enacted securities laws in favour of just regulation by securities exchanges might make it difficult for issuers to make a credible commitment to the particular set of disclosure obligations set out by any given securities exchange.[79] On the other hand, an issuer might be able to put restrictions on

[77] See Marcel Kahan, "Some problems with Stock Exchange-based Securities Regulation" (1997) 83 Virginia L. Rev. 1509 [Kahan, "Stock Exchange-based"] at 1510-14. Kahan also questions whether securities exchange interests are necessarily consistent with investor interests (at 1512-13).
[78] See in *infra* Part 5, ii, e).
[79] On the limits to securities exchange enforcement mechanisms see Kahan, *supra* note 77, at 1517. Kahan also questions the incentive of an exchange to police and enforce its rules, since the optimal image for the exchange to convey to the public is that there are no violations, and such an image is damaged when a violator is discovered and punished (see *ibid.* Kahan, at 1518).

changing an exchange listing in its constating documents.

d) Investor Regulation

One particularly provocative suggestion that has been made is that instead of regulating the issuers we should be regulating the investors.[80] In this proposal, instead of subjecting the issuers to disclosure requirements, investors would be protected by limiting what they could invest in depending on their degree of sophistication. The more sophisticated the investor the broader the range of things the investor could invest in. The less sophisticated the investor, the narrower the range of things the investor could invest in. Very sophisticated investors would have no limits on what they could invest in. Very unsophisticated investors would be limited to very low risk investments or a very limited choice of indexed funds (i.e. a portfolio of securities managed by someone else on their behalf who is sophisticated and who creates a portfolio of investments that matches the securities included in a broad-based market indicator). To assess the degree of sophistication investors would be required to write an exam testing their degree of investment sophistication.

Under this proposal one would presumably still need registered brokerage firms that would have to meet financial adequacy requirements and would be expected to know the creditworthiness of their clients to ensure the market that orders made would indeed be executed. In other words, registered brokerage firms would be needed to provide certainty of securities transaction performance as discussed in Part 4, vii, above.

e) Reduced Disclosure Based on Investor Behaviour Theory

Requirements imposed on issuers on the distribution of securities and to support secondary market trading has focused on disclosure of information. It has not focused on how that information is used and how effectively it is used. Investors, as individual human beings, or as institutions managed by human beings, have limited abilities to gather and assess information. Studies of decision-making behaviour suggest that as information increases, decision-making improves but that the quality of decision-making peaks and then actually decreases as the quantity of information increases. This suggests that there can be too much information.[81]

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[80] Stephen Choi, "Regulating Investors Not Issuers: A Market-Based Proposal" (2000) 88 Cal. L. Rev. 279

[81] For a discussion of potential concern with respect to excessive disclosure and its potentially negative impact on decision-making in light of evidence on human behaviour see Paredes, *supra* note 63.

Securities regulation in many jurisdictions around the world has seen increasing amounts of disclosure. Prospectuses can be very long, and continuous disclosure documents have increased both in terms of the number of documents that must be filed and in terms of the detail of disclosure in such documents. The amount of information available concerning a given issuer can be staggering. There is a cost to producing the information, and it would be a wasted expenditure if information is being produced that is not being used (i.e. providing no benefit). It would be an even worse waste of resources to produce the information if it was actually producing poorer-quality decisions.[82]

This suggests that perhaps less information should be disclosed. The question, however, is, firstly, whether the amount of disclosure has reached the point that it is starting to produce poorer-quality decisions. If it has reached that point, the second question would be what information should be deleted? This would depend on how investors use the information. It may be the case that different types of investors with different capacities to gather and assess information may use information in different ways, employing different decision-making strategies. In short, before a disclosure reducing reform can be implemented, a great deal more study would need to be done to determine how various investors use the information that is currently being provided.

One difficulty with a review of specific items of disclosure is that issuers are required to provide a certificate that their disclosure constitutes "full, true and plain disclosure of all material facts".[83] Further, although specific items are required in prospectus forms, they can be left out where they are inapplicable.[84] Thus a reduction in the specific items to be addressed in a prospectus would arguably not limit the amount of disclosure. Material items no longer included in the list would still have to be addressed. It seems, however, that issuers and underwriters, out of an abundance of caution, will be inclined to address a specific item of required disclosure even though it may not be material. Gathering the information to respond to such items can be costly and can lead to additional administrative costs in reviewing the disclosure, while contributing to potential information overload for investors. Reducing the specifically required items could reduce these costs.

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[82] *Ibid.* at *e.g.* 419, 441-43, and 458-59.
[83] See the wording of the certificate the issuer is required to provide in *e.g.* the *Securities Act*, R.S.B.C. 1996, c. 418, [B.C. *Securities Act*] s. 68; and the Ontario *Securities Act*, R.S.O. 1990, c. S.5, [Ontario *Securities Act*] s. 58.
[84] See, e.g., BC Form 41-601F, Instruction (6).

6. <u>Insider Trading</u>

The prohibition of insider trading is another major element of securities regulation. This part notes how the prohibition of insider trading may improve the competitiveness of a capital market. It then notes the debate over insider trading and the argument that permitting insider trading may actually improve the competitiveness of a capital market. The debate raises empirical questions that, at one time, seemed intractable. However, empirical evidence over the last decade and a half is beginning to address the question of whether prohibiting insider trading actually improves the competitiveness of a capital market. The summary of the debate on insider trading is thus followed with a review of some key empirical studies on the effects of insider trading.

i. How the Prohibition of Insider Trading May Improve the Competitiveness of a Capital Market

a) The Perceived Problem

As noted in Part 5, the continuous disclosure requirements are intended to provide information in support of secondary market trading. One of the principles behind the disclosure of material changes by reporting issuers is that investors should, ideally, have equal access to information. If this ideal could be achieved, no trader, even an "insider," would have an advantage in terms of access to information. However, this ideal result may not be achieved for three reasons. First, the reporting issuer may fail to disclose some information, even where that information should have been disclosed. Second, securities laws allow information to be kept confidential in circumstances where disclosure could be detrimental to the issuer or where proposed decisions have yet to receive required approvals. "Insiders" may nonetheless have access to this information. Third, even if the information has been disclosed, it will take time for that information to be sufficiently widely disseminated to provide equal access.

Thus, in spite of continuous disclosure requirements, there may be persons who have access to material information that has not been disclosed or widely disseminated in the market. They will have better access to information than other investors. Should these persons be prohibited from trading on the basis of this access to information that has not been publicly disclosed? Academic discussion justifying the prohibition of insider trading dates back at least to as early as an article in 1910 by H.L. Wilgus.[85] Wilgus

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[85] H.L. Wilgus, "Purchase of Shares of Corporation by a Director from a Shareholder" (1910) 8 Mich. L. Rev. 267.

argued that insider trading was inherently unfair and thus morally offensive. Adolph Berle, agreeing with Wilgus, also wrote in favour of prohibiting insider trading.[86] These views were also reflected in Congressional hearings in the United States leading up to the *Securities Act of 1933* and the *Securities Exchange Act of 1934*.[87]

What is it that is inherently unfair and thus morally offensive about insider trading? The Kimber Report recommended statutory provisions prohibiting insider trading. The view expressed in the Kimber Report was that,

> The ideal securities market should be a free and open market with the prices thereon based upon the fullest possible knowledge of all relevant facts among traders. Any factor which tends to destroy or put in question this concept lessens the confidence of the investing public in the marketplace and is, therefore, a matter of public concern.[88]

Insider trading was apparently considered by the Kimber Commission to be a "factor which tends to destroy or put in question" the concept of a "free and open market". If market prices are not based on "the fullest possible knowledge of all relevant facts", investors face the risk of selling for too low a price when there is favourable material information which is undisclosed, and of paying too high a price when there is unfavourable material information which is undisclosed. This risk reduces investor "confidence … in the marketplace" causing investors to discount the prices they are willing to pay for securities.[89]

Paying lower prices for securities up front (i.e., discounting the value of securities) would reduce the size of a loss that might occur where the investor lacked access to unfavourable information about the securities. Also paying a price that is less than the security is actually worth can allow them to be compensated, or at least partially compensated, if they subsequently sell at too low a price, lacking access

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[86] Adolph A. Berle, Jr., "Publicity of Accounts and Directors' Purchase of Stock" (1927) 15 Mich. L. Rev. 827.
[87] *Ibid.*
[88] *Kimber Report*, *supra* note 1 para. 2.02.
[89] See also, e.g., Louis Loss, "The Fiduciary Concept as Applied to Trading by Corporate 'Insiders' in the United States" (1970) 33 Mod. L. Rev. 34, at 36 where it is argued that insider trading constitutes a "grievous insult to the market in the sense that the very preservation of any capital market depends on liquidity, which rests in turn on the investor's confidence that current quotations accurately reflect the objective value of his investment"; and Joel Seligman, "The Reformulation of Federal Securities Law Concerning Non-public Information" (1985) 73 Geo. L.J. 1083, at 1115-21 where it is noted that the main policy reason for proscribing insider trading is to "make investors confident that they can trade securities without being subject to informational disadvantages" (at 1115) and discussing the overall goal of "guarantee[ing] the integrity of the market" (at 1115).

to favourable information about the securities.[90] This discounting of prices in the secondary market will be reflected in primary market securities prices since investors in that market will take into account the reduced price at which securities can be sold in the secondary market.[91] Investors purchasing securities in the primary market may also tend to make a downward adjustment in the price they are willing to pay to account for a potential subsequent sale at too low a price due to a trade with an insider who has access to favourable information about the securities. Reduced prices in the primary market will affect the supply of capital and the allocation of resources.[92]

b) The Benefits of Prohibiting Insider Trading

Prohibiting insider trading can reduce the risk to investors of selling for too low a price when there is favourable material information that is undisclosed, and of paying too high a price when there is unfavourable material information that is undisclosed. It thus improves investor "confidence in the marketplace". The improved confidence in the market should reduce the investor incentive to discount securities prices. Securities prices should thus come to more closely reflect their underlying values. The incentive to save and invest should increase, causing more funds to be allocated to investment and contributing to economic growth. Issuers may be more inclined to issue securities in markets that prohibit insider trading, since higher prices for their securities in those markets should give them an overall lower cost of capital.

ii. The Insider Trading Debate

In 1966 Henry Manne challenged this received wisdom.[93] This stemmed a debate that has produced an

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[90] See Lawrence M. Ausubel, "Insider Trading in a Rational Expectations Economy" (1990) 80 A.E.R. 1022 where it is argued that insider trading deters investment in securities markets by outsiders who want to avoid dilution of their returns on investment caused by insider trading.
[91] See the *Kimber Report*, *supra* note 1 at paras. 1.11-1.12.
[92] *Ibid.*
[93] Henry G. Manne, *Insider Trading and the Stock Market* (New York: Free Press, 1966) [Manne, *Insider Trading and the Stock Market*]. Manne's arguments are briefly explained in the text that follows. In general terms, however, Manne argued that "(1) there [was] no coherent theory explaining the regulation of insider trading; (2) there [was] no significant injury to [the issuer's] investors from insider trading; and (3) insider trading constitutes the most appropriate device for compensating entrepreneurs in large corporations." See Robert B. Thompson, "Insider Trading, Investor Harm, and Executive Compensation" (1999) 50 Case Western Law Review 291 at 291. Manne later suggested that trading by insiders might also improve the accuracy of securities market prices by causing securities prices to reflect the undisclosed information more quickly than they would have if trading by insiders was prohibited prior to disclosure. See Henry G. Manne, "Insider Trading and the Law Professors" (1970) 23 Vanderbuilt L. Rev. 547, at 565-75.

enormous amount of literature too voluminous to review here.[94] Two general types of arguments were made that question the prohibition of insider trading. First, it has been argued that insider trading does not *cause* a loss to other investors. Second, there are arguments to the effect that allowing insider trading may make the market more efficient (and therefore more competitive). Each of these arguments is briefly described below.

a) Causation: Insider Trading as a "Victimless Crime"[95]

The essence of the argument that insider trading does not cause a loss is that an investor engaging in the anonymous trading of a securities market will make a trade regardless of whether or not there is any insider trading. Consider, for example, that the shares of a particular issuer are trading at around $10 per share, but that there is favourable undisclosed information about a share that suggests the shares are worth around $14 per share. If an investor is unaware of the undisclosed information, that investor may choose to sell her or his shares at $10 per share even if there are no insider trades. Had the investor known of the undisclosed information, he or she probably would not have sold the shares at $10 per share. The investor has thus lost about $4 per share. However, the loss was not due to any insider trading since there *was* no insider trading. The loss was due to a lack of knowledge of the undisclosed information. Had there been insider trading, and if that insider trading was enough to affect the price of the shares,[96] the investor

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[94] The literature is too voluminous to list here. For reviews of the literature see, e.g., F.H. Easterbrook, "Insider Trading as an Agency Problem" in J.W. Pratt & R.J. Zechauser, eds., *Principals and Agents: The Structure of Business* (Boston: Harvard Business School Press, 1985) chapter 4, 82-100; F.H. Easterbrook & D.R. Fischel, *The Economic Structure of Corporate Law* (Cambridge, Mass.: Harvard University Press, 1991) chapter 10; William K.S. Wang & Marc I. Steinberg, *Insider Trading* (Aspen Law & Business, 1996); Mark R. Gillen, *Securities Regulation in Canada* (Scarborough, Ont.: Carswell, 1998) 344-59; Charles C. Cox & Kevin S. Fogarty, "Bases of Insider Trading Law" (1988) 49 Ohio St. L.J. 353, at 354-60; Boyd K. Dyer, "Economic Analysis, Insider Trading, and Game Markets" [1992] Utah L. Rev. 1, at 11-39; and Stephen Bainbridge, "The Law and Economics of Insider Trading: A Comprehensive Primer" (February, 2001 – available from the Social Science Research Network) at 61-84.

[95] See, e.g., Manne, *Insider Trading and the Stock Market*, *supra* note 93, at 93-108; M.P. Dooley, "Enforcement of Insider Trading Restrictions" (1980) 66 Va. L. Rev. 1 at 33, 36, 55, and 68; K.E. Scott, "Insider Trading: Rule 10b-5, Disclosure and Corporate Privacy" (1980) 9 J. of Legal Studies 801, at 807 and 809. See the summary in Bainbridge, *supra* note 94, at 71-75.

[96] Whether insider trading can in fact be sufficient to affect the price of securities is an empirical question. See Part 6, iii, b), on the effect of insider trading on securities values.

would have suffered less of a loss since insiders would have driven up the price above $10 per share.[97] It is this notion that insider trades do not directly cause investors to suffer losses that has led to the description of insider trading as a "victimless crime."

Counterarguments have been made suggesting situations in which trading by insiders might actually directly cause non-insider investors to trade and perhaps suffer a loss as a consequence of the insider trading.[98] These situations are not likely to be particularly common and even then they may not always cause investors to suffer a loss.[99] Insider trading may, however, cause an indirect loss to non-insider investors.[100] The argument for this indirect loss is that the number of outstanding units of a particular security of an issuer is normally fixed unless the issuer is issuing more of the securities or is repurchasing some of the securities. Consider an insider who owns shares of a particular issuer and sells some of those shares on the basis of undisclosed unfavourable inside information about the issuer. With the total number of the outstanding shares fixed, the insider will end up with less of those shares and some non-insider investors must end up with more of those shares. A fall in the price of the shares in response to the subsequent disclosure of the unfavourable information will cause the non-insider investors who end

[97] The institutional investors who bought shares in Doman Industries Ltd. from the Bennetts may have considered themselves be the victims of insider trading. But they were apparently engaged in arbitrage trading relating to the proposed takeover of Doman Industries by Louisiana Pacific. They may have thus been the type of investors who would have ended up buying the shares even if the Bennetts had not traded. They thus might well have suffered the loss even if there was no insider trading. If so, if they discovered that their trades were with the Bennetts and obtained compensation from the Bennetts for their losses based on a civil action for insider trading under provincial securities legislation, it would have amounted to a penalty to the Bennetts and a windfall gain for the institutional investors (since they probably would have lost the money even if there was no insider trading). The circumstances of the trades by the Bennetts are set out in *R. v. Bennett*, [1989] B.C.J. No. 1884.

[98] Suppose, for example, that an investor places an order to sell at $11 at a time when the shares are trading at around $10 per share. Insider trading on favourable information that suggests the shares are worth $14 could drive the price up to $11 thereby causing the trade and a loss to the investor of $3 per share. The difficulty with this scenario in terms of causing a loss from insider trading is that the loss might well have occurred without insider trading. If the information was disclosed, trading by non-insiders on the basis of the favourable information would likely have caused the price to rise and the investor would have had to move quickly to cancel the standing order before it was executed. If the order was executed before it could be cancelled, there would be a sale at $11 per share and a loss of $3 per share even without any insider trading.

An insider's trade might cause a loss if, for example, there is undisclosed favourable information suggesting the shares are worth $14 per share and the insider's bid (e.g., $11 per share) may be the only available bid at the particular price (i.e., $11). The investor may sell the shares at $11 believing that to be a price that is greater than what the shares to be worth on the basis of the available information and the price of the last quoted trade (at say $10 per share). The investor would have then sold shares at less than what they are worth in light of the undisclosed favourable information. The investor's sale of shares would have been caused by the price increase due to insider trading. Indeed, bids by insiders may have been the only bids available at the higher price. Whether the bid (or ask) price of an insider is likely to be the only bid (or ask) available depends on the extent to which trades by insiders affect securities prices.

[99] See the situations described *supra* note 98.

[100] William K.S. Wang, "Stock Market Insider Trading: Victims, Violators and Remedies – Including an Analogy to Fraud in the Sale of a Used Car with a Generic Defect" (2000) 45 Villanova Law Review 27. See also Wang & Steinberg, *supra* note 94 at 41-105.

up with more of the shares to be worse off, while the insider who disposed of the shares before the drop in price will be better off. There must, therefore, be some investors who are worse off. If the insider had not traded, some persons would have been worse off if they sold before the unfavourable information was disclosed. However, trading by the insider must increase the number of persons who are made worse off.

A similar argument can be made for insider trading on undisclosed favourable information. Insiders would buy shares and end up with more of the shares prior to the disclosure of the favourable information. Non-insiders collectively would end up with less of the shares, with some non-insider investors selling to insiders. Thus the insiders as a group would end up with more of the gain on the disclosure of the information relative to non-insiders as a group.

It may not be easy to trace the specific party who was made worse off by an insider trade. Consider the case of insider trading on undisclosed unfavourable information. A person who traded with the insider may have sold some or all the shares before the unfavourable information was disclosed and may have thereby avoided all or much of the loss. The person who bought the shares in that subsequent transaction may also have sold those shares before the unfavourable information was disclosed and may also have thereby avoided all or most of the loss.

What the investor really needs to adjust for is not the risk of trading with an insider, but the much more significant risk of trading when there is undisclosed material information (even when insiders are not trading). The presence of undisclosed material information is the real source of risk that one might pay too much for securities or sell them for too little. Call this, for ease of reference, the "uninformed trading risk." The presence of insider trading, as noted above,[101] arguably increases the overall amount of trading in the presence of undisclosed information and thus increases this uninformed trading risk. It is this incremental risk that the investor should adjust for, and it is this incremental adjustment (or discount) that may affect the allocation of financial resources or the allocation between savings and consumption as a result of insider trading.

Thus, insider trading may lower the overall value of securities to the extent it increases the discount for uninformed trading risk. Securities laws typically prohibit insider trading. To the extent the prohibition deters insider trading, it should reduce the degree of uninformed trading risk and thereby reduce the amount of the discount non-insider investors need to make for the uninformed trading risk.

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[101] *Ibid.*

b) Societal Benefit or Harm

This argument of broader investor harm from insider trading is addressed in a second set of arguments that challenge the prohibition of insider trading. These arguments point to potential overall benefits from allowing insider trading, in terms of raising the value of securities in the market as a whole and by improving securities price efficiency (thereby improving the efficiency of the allocation of financial resources). Henry Manne made two arguments of this type. First, Manne argued that allowing managers to trade on inside information as a form of compensation better aligns the interests of managers with the interests of investors. Second, Manne argued that insider trading can improve the accuracy of securities prices by causing securities prices to more quickly reflect undisclosed information than if trading by insiders was prohibited until the information was publicly disclosed.[102]

Insider Trading as an Agency Cost-Reducing Compensation Technique

The compensation argument is related to the concern over the separation of ownership and control that has long been an acknowledged concern in the corporate governance context.[103] The separation of ownership and control concern is that where the persons managing an enterprise have relatively limited investment interests (particularly equity interests) in the enterprise, they may not be motivated by quite the same interests that the investors (or owners) may have in the enterprise. Economists have analyzed

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[102] See Henry G. Manne, "Insider Trading and the Law Professors" (1970) 23 Vanderbilt L. Rev. 547.

[103] Adolf A. Berle & Gardner C. Means, *The Modern Corporation and Private Property* (New York: Commerce Clearing House, 1932). See also the papers in the symposium on the book fifty years after its publication at (1983) J. of L. & Econ. 235-496.

this as an "agency cost" problem.[104] One way of attempting to align the interests of managers and investors to reduce agency costs is through compensation techniques. Profit bonuses and stock options would be examples of techniques that, if used properly, might help to align the interests of managers and investors (i.e., to reduce agency costs). Manne argued that the problem with techniques such as profit bonuses and stock options is that they do not provide a very close alignment of good performance and compensation. Profit bonuses, for instance, cannot be determined until the profit is assessed, and the assessment of profit tends to be done at infrequent intervals. Consequently, the bonus may not be given to the managers until long after the performance that led to the increased profit. Further, the bonus tends not to just reward the particular manager or managers who brought about a profit-producing event: it also rewards persons who have not contributed to it and who may, in fact, have performed poorly. In the case of stock options, some (or perhaps many) of the managers who benefit from exercising their stock options may not have been the managers whose efforts led to an increase in the share price. However, managers who have been involved in the activities that will lead to a share price increase are likely to be the first persons who know of those activities, and will thus be able to benefit immediately by insider trading if insider trading is allowed.[105]

Many criticisms have been made of this compensation argument. Several of these criticisms point to

[104] This agency cost problem was noted in the discussion of mandatory disclosure in Part 4, vi, above. In this "agency cost" analysis managers are described as "agents" of investors since they act (in a general, non-legal sense) on behalf of investors. The interests of the managers may, unfortunately, not be entirely consistent with the interests of the investors. The managers may not want to work quite as diligently as the investors would like them to. The managers might also be tempted to divert some of the funds received from investors to their own use or benefit, rather than devoting them to the activities of the business in a way that is in the best interests of the investors. From the perspective of the investors this risk of lack of diligence (sometimes referred to as "shirking"), or the diversion of funds (sometimes referred to as "looting"), is a potential cost of the investment. This potential cost arising from the divergence of manager and investor interests is referred to as an "agency cost". Steps can be taken to reduce this potential cost. For instance, the investors may try to carefully monitor the managers, or they may try to find compensation techniques that tend to better align the interests of investors and managers. These steps, however, can also involve costs. At some point the cost of additional steps to address the potential costs of divergent manager and investor interests may outweigh the savings in terms of reduced potential costs of divergent manager and investor interests. On the agency cost approach to the separation of ownership and control see, e.g., Michael Jensen & William H. Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure" (1976), 3 J. of Financial Economics 305; Eugene Fama, "Agency Problems and the Theory of the Firm" (1980) 88 J. of Political Economy 288; Eugene Fama & Michael Jensen, "Separation of Ownership and Control" (1983) 26 J. of Law and Economics 301; Eugene Fama & Michael Jensen, "Agency Problems and Residual Claims" (1983) 26 J. of Law and Economics 327; Frank Easterbrook & Daniel Fischel, "Corporate Control Transactions" (1982) 91 Yale L.J. 698; and Ronald Gilson, "A Structural Approach to Corporations: The Case Against Defensive Tactics in Takeovers" (1981) 33 Stan. L.R. 819.

[105] See generally Manne, *Insider Trading and the Stock Market*, *supra* note 93 at 131-145.

ways in which allowing insider trading may actually exacerbate agency costs.[106] Thus the argument and the criticisms made raise an empirical question: does permitting insider trading increase or reduce agency costs (or similarly, does prohibiting insider trading reduce or increase agency costs)?

More Efficient Pricing

Securities markets provide a more efficient allocation of financial resources when securities prices more accurately track the underlying values of securities. If insider trading is effectively prohibited securities prices are not likely to respond to new information until the information has been publicly disclosed. If insider trading is permitted, and if insider trading is sufficient to affect securities prices, then a securities price response to insider trading will cause the price of the security to move closer to its underlying value.

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[106] There is, for instance, a *windfall gains* argument that notes that many managers who do not take part in particular gain producing activities can still benefit from insider trading not because of their efforts but simply because, as insiders, they have better access to information about the gain producing activities. This criticism was recognized and discussed by Manne, *Insider Trading and the Stock Market*, *supra* note 93 at 156-58. The argument is also discussed by Easterbrook, *supra* note 94 at 84.

There is also *perverse performance* argument that notes that perverse performance incentives might arise from allowing insider trading because managers could engage in loss-creating activities and benefit by short selling the issuer's securities. See S. Levmore, "Securities and Secrets: Insider Trading and the Law of Contracts" (1982) 68 Virg. L. Rev. 117, at 149; and R.A. Schotland, "Unsafe at Any Price: A Reply to Manne" (1967) 53 Va. L. Rev. 1425, at 1453-54.

Then there is an *information hoarding* argument that suggests managers would have an incentive to hoard information so that they could benefit from trading on it. This would interfere with the efficient flow of information in the firm that is necessary for effective management. See R. J. Haft, "The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation" (1982) 80 Mich. L. Rev. 1051 at 1053-60; David Ferber, "The Case Against Insider Trading: A Response to Professor Manne" (1970) 23 Vand. L. Rev. 621, at 623; Joel Seligman, "The Reformulation of Federal Securities Law Concerning Non-public Information" (1985) 73 Geo. L.J. 1083 at 1119 and 1121; Morris Mendelson, "The Economics of Insider Trading Reconsidered" (1969) 117 U. Pa. L. Rev. 470 at 489; Roy A. Schotland, "Unsafe at Any Price: A Reply to Manne" (1967) 53 Va. L. Rev. 1425, at 1448-49.

There is also a *moral hazard* argument noting that that managers may prefer to take higher risks in order to create greater fluctuations in the prices of the issuer's securities so that they can reap greater benefits from insider trading. See Easterbrook, *supra* note 93 at 86-87.

Further, there is an *adverse selection* argument according to which allowing insider trading promotes a selection of managers that is "adverse" in the sense that it promotes the hiring of managers who are more inclined to take risks because they are willing to work for a lower salary and supplement their compensation in the form of insider trading gains. See Easterbrook, *supra* note 94 at 87-89.

Plausible responses have been made to each of these criticisms. On the *windfall gains* criticism see Manne, *Insider Trading and the Stock Market*, *supra* note 93 at 134-39; and Easterbrook, *supra* note 94, at 83-84. On the *perverse performance incentive* criticism see Manne, *Insider Trading and the Stock Market*, *ibid.* at 150-51; and D.W. Carlton & D.R. Fischel, "The Regulation of Insider Trading" (1983) 35 Stan. L. Rev. 857 at 872-74. On the *information hoarding* criticism see Manne, *Insider Trading and the Stock Market*, *ibid.* at 134-39; Easterbrook, *ibid.* at 83-85; R.A. Dye, "Insider Trading and Incentives" (1984) 57 J. of Bus. 295; and Dooley, "The Enforcement of Insider Trading Restrictions" (1980) 66 Va. L. Rev. 1, at 34. On the *moral hazard* criticism see Easterbrook, *ibid.* at 86-87; and R.A. Dye, *ibid.* And on the *adverse selection* criticism see Carlton & Fischel, *ibid.* at 871-72 (but for a response to Carlton and Fischel on the adverse selection criticism see N.L. Georgakopoulos, "Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading Regulation" (1993) 26 Connecticut L. Rev. 1 at 4).

Consider a particular issuer's shares that are trading at about $10 per share. Suppose there is favourable undisclosed information suggesting the price should be about $14 per share. Buy orders by insiders should put upward pressure on the price of the shares, thereby moving the price closer to its underlying value of $14 per share. Non-insider investors may observe the price change and increase in the volume of trading due to insider trades and conclude that there is some as-yet-undisclosed favourable information about the issuer. This may cause these non-insider investors to buy thereby further moving the price of the shares towards their underlying value.

An early criticism of this argument in favour of insider trading was that insider trading would probably have only a small and insignificant impact on securities prices.[107] If this is the case, then insider trades themselves may provide little benefit in terms of causing securities prices to track their underlying values more quickly. If the impact of insider trading is small and insignificant, it will probably not cause non-insider investors to detect the presence of undisclosed information that would cause them to trade in the same direction.

A more recent criticism of the efficient pricing argument is that insider trading leads to less efficient pricing. The argument, indeed, is that it is the prohibition on insider trading that leads to more efficient pricing.[108] The argument can be expressed in terms of a timeline for access to information. Insiders and their tippees will be the first persons with access to information. When the information is disclosed, the next persons who are likely to get the information, analyze it and trade on it, are the more sophisticated investors - such as securities analysts and institutional investors. Securities analysts and institutional investors are likely to be the first persons to gather, analyze and trade on the information since they have the financial resources and experts needed to gather available information quickly, analyze it and trade on it. The cost of gathering and analyzing the information is justified if there are likely to be sufficient

[107] See, e.g., Richard Brealey, *An Introduction to Risk and Return from Common Stocks*, 2d ed. (Cambridge, Mass.: MIT Press, 1983) at 35-44; F.H. Easterbrook, "Insider Trading, Secret Agents, Evidentiary Privileges and the Production of Information" [1981] Sup. Ct. Rev. 309 at 335-36; and R.J. Gilson & R. H. Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 Virg. L. Rev. 549 at 629-34. Gilson and Kraakman suggest that the mechanism by which insider trading is likely to affect the price is not the insider trading itself, but non-insider trading derived from inferred knowledge of insider trades which Gilson and Kraakman suggest is also likely to operate slowly and have little affect on the price. They suggest that if insider trading were to be permitted and if efficiency is the objective, then there should be a requirement for earlier disclosure of the trades (preferably prior to the trades) to allow derivatively informed trading to operate more effectively.

[108] See Georgakopoulos, *supra* note 106. For arguments along similar lines see Note, "Insider Trading in a Rational Expectations Economy" (1990) 80 American Economic Review 1022; L.R. Goldstein & P. Milgrom, "Bid, Ask and Transaction Prices in a Specialist Market with Heterogeneously Informed Traders" (1985) 14 J. Fin. Econ. 71; M. Manove, "The Harm from Insider Trading and Informed Speculation" (1989) 104 Q.J. Econ. 823; and Michael J. Fishman & Kathleen M. Hagerty, "Insider Trading and the Efficiency of Stock Prices" (Working Paper, Kellogg Graduate School of Management).

profits from trading on the information. If insider trading is permitted, then insider trading profits will reduce the profits that non-insiders can make from gathering, analyzing and trading on information. The reduced profits to non-insiders will reduce their incentive to incur the costs of gathering, analyzing and trading on information. They will do less gathering and analysis of information and less trading on that information. With less information-gathering, analysis and trading, the speed at which the market will react to the information when it does become publicly announced will be reduced.

It is also argued that the reduced profits to non-insiders from gathering, analyzing and trading on information due to permitting insider trading will reduce the overall amount of trading thereby reducing liquidity. The reduced liquidity of the market will lead to lower securities values, since liquidity is something of value to investors.

The mechanism by which reduced liquidity may come about is that market-makers or specialists who either trade to maintain a market in the securities or trade to provide smooth transitions in securities prices suffer losses from insider trades.[109] The problem for market-makers and specialists is described as an adverse selection problem. Since they will lose in trades with informed insiders who have better information, they might charge a premium for trades with insiders. However, since they can't distinguish between informed insiders and uninformed investors, they have to compensate themselves for losses in trades with informed insiders by charging the compensation premium on all trades. They do this by increasing the bid-ask spread. This raises the costs to investors from securities transactions, reducing trading and thus reducing liquidity.[110]

The debate concerning the effect of the prohibition of insider trading on securities market prices raises empirical questions such as whether insider trading has an affect on securities prices and whether it increases or decreases liquidity.

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[109] See, e.g., Larry Harris, *Trading and Exchanges: Market Microstructure for Practitioners* (2003) at 286-91; Jack L. Treynor, "Securities Law and Public Policy", Fin. Analysts J. (May-June 1994) 10 at 10; Maureen O'Hara, *Market Microstructure Theory* (Cambridge, Mass. : Blackwell Business, 1995) at 54; J. Chris Leach & Ananth N. Madhavan, "Price Experimentation and Security Market Structure", (1993) 6 Rev. Fin. Stud. 375, at 376; Yakov Amihud & Haim Mendelson, "Asset Pricing and the Bid-Ask Spread" (1986) 17 J. Fin. Econ. 223, at 223-24.

[110] This adverse selection argument is briefly described in Stanislov Dolgopolov, "Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market" (2004) 33 Cap. U.L. Rev. 83, at 89.

iii. Empirical Evidence

a) The Implicit Empirical Evidence Argument

Early on in the debate over whether or not insider trading should be prohibited, it was suggested, in the absence of more direct empirical evidence, that there was implicit evidence of the benefit of allowing insider trading prior to the prohibition of insider trading in North America under securities laws. The evidence, it was said, was that issuers did not themselves impose prohibitions of insider trading. If a prohibition of insider trading had been beneficial for issuers, then surely they would have imposed a prohibition on their own. [111]

One response to this was that managers controlling issuers would not impose a prohibition on insider trading that would take away the benefits they received from insider trading.[112] The response to this criticism was that if a prohibition of insider trading was really beneficial for issuers and investors in terms of increased securities values, managers could prohibit insider trading and share the net gains between investors and themselves in the form of higher non-insider trading management compensation. If insider trading was really bad for issuer performance, a competitor could impose a ban on insider trading raising its securities prices and lowering its cost of capital. This would allow it to outperform and out-compete the issuer that allowed insider trading.[113]

A perhaps stronger explanation for issuers not imposing a ban on insider trading themselves before it was imposed under securities laws is that the costs of enforcing such a ban may have outweighed the gains.[114] Without taking enforcement costs into account, banning insider trading may have yielded benefits and thus net gains to the issuer and corresponding increases in the values of the issuer's securities. If, however, enforcement costs were taken into account, there may have been a net loss to the issuer with a

[111] Carlton & Fischel, *supra* note 106 at 858-60. See also F.H. Easterbrook, *supra* note 94 at 90.
[112] V. Brudney, "Insiders, Outsiders and Informational Advantages under the Federal Securities Laws" (1979) 93 Harv. L. Rev. 322; R.J. Haft, "The Effect of Insider Trading Rules on the Internal Efficiency of the Large Corporation" (1982) 80 Mich. L. Rev. 1051 at 1058.
[113] See Carlton & Fischel, *supra* note 106 at 857-58; and Easterbrook, *supra* note 94 at 90-91. Others have argued that defects in the labour market in which management contracts are created would prevent firms from prohibiting insider trading by private agreement. Jesse M. Fried, "Reducing the Profitability of Corporate Insider Trading Through Pre-trading Disclosure" (1998) 71 S. Cal. L. Rev. 303 at 315 (who argues that the managerial labour market is not as tightly constrained by competition as other markets); Gilson & Kraakman, *supra* note 107 at 632, note 221 (who argue that there is a lack of market checks on insider trading); and D. Krawiec, "Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age" (2001) 95 Nw. U.L. Rev. 443 at 497 (who argues that it is unlikely that market forces would constrain decisions to opt out of insider trading laws).
[114] Easterbrook, *supra* note 94 at 91-92.

corresponding decrease in the values of the issuer's securities.

While there may have been a loss net of enforcement costs for individual issuers in prohibiting insider trading, there may have been net gains to a collective prohibition of insider trading if there were economies of scale in the enforcement of an insider trading prohibition.[115] A collective ban among numerous issuers might have been difficult to obtain if some issuers chose to hold out against sharing in the costs of a joint enforcement mechanism, hoping to free-ride on the enforcement efforts of others. A government-imposed regulatory enforcement would have been one way to overcome this potential holdout behaviour by issuers. Enforcement through a securities exchange might have been another way to overcome this potential holdout behaviour by issuers.[116] If prohibiting insider trading really provided benefits net of the joint enforcement costs, the securities exchange would benefit from increased prices of the securities listed on the exchange. The increased securities values would attract investors to the securities listed on that exchange. Issuers would want to list on that exchange to get higher prices for their securities and the lower cost of financing associated with those more highly priced securities.

A government-imposed enforcement mechanism may, however, have an enforcement advantage over a securities exchange enforcement mechanism. The key enforcement mechanism for a securities exchange would be to suspend the issuer's listing or delist the issuer's securities. An exchange might be able to threaten delisting if an issuer did not itself address an insider trading problem by at least dismissing those responsible for either insider trading or the leakage of information. The advantage to a government-imposed enforcement mechanism is that it could add much more significant sanctions to deter insider trading. It could impose penal sanctions that the exchange could not impose and a government-imposed prohibition on insider trading could be enforced with a range of administrative and civil sanctions that an exchange might not be able to impose.[117]

The prohibition of insider trading in North America may have coincided with the development of computer technology. Computerized stock watch programs may have reduced enforcement costs by facilitating detection of potential insider trades. As enforcement costs decreased, the perceived net

[115] *Ibid*., at 93. See also Gilson & Kraakman, *supra* note 107 at 634, note 224. Carlton & Fischel have argued that enforcement problems only explain a need for collective enforcement but not a mandatory prohibition. See Carlton & Fischel, *supra* note 106 at 863-64.
[116] See Easterbrook, *supra* note 94 at 93. See also Mahoney, "Exchange as Regulator", *supra* note 76 at 1458-9 on stock exchanges operating as a means through which issuers of securities can overcome collective action problems with respect to obtaining an optimal level of disclosure.
[117] See Easterbrook, *supra* note 94 at 93-94. See also Kahan, "Stock Exchange-based", *supra* note 77 at 1517 noting enforcement limitations of stock exchanges.

benefits of banning insider trading (net of enforcement costs) may have become positive, making a prohibition of insider trading worthwhile.[118]

It should be noted as well that the net benefit from a prohibition of insider trading should also be net of the costs of compliance by issuers, investors, securities industry participants and all others who may have obtained access to insider information. Thus the potential insider trading prohibition benefits of increased "confidence in the market", reduced agency costs, and securities price accuracy or liquidity should be net of the costs of enforcement and compliance.

b) More Recent Empirical Evidence

Insider Trading and Executive Compensation

A few studies have examined the relationship between insider trading and executive compensation. Permitting insiders to profit from trades on inside information may allow other forms of compensation to be reduced, thereby lowering the overall cost of compensation. A 1990 study found no relation between insider trading profits and the level of insider cash compensation.[119] A study in 1997 found, after controlling for the effect of differences in firm size, that as the number of insiders in a firm increases, the level of salary, bonuses and stock compensation increase. This suggested that as individual insider trading profits were decreasing due to competition for insider profits, other forms of compensation were being increased to compensate for the reduced insider trading profits.[120] This then suggested that higher potential insider trading profits were associated with lower levels of other forms of executive compensation. A more recent study in 2001 found that firms with internal restrictions on insider trading during certain times, such as periods before and after earnings announcements, paid an executive compensation premium of between 4 to 15% over firms that did not have such internal insider trading restrictions.[121] This apparent empirical connection between the prohibition of insider trading and higher forms of other compensation suggests that whatever other benefits the prohibition of insider trading might provide, they must be sufficient to compensate for the increased executive compensation.

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[118] See Easterbrook, *supra* note 94 at 93.
[119] T. Trapani, "The Relationship Between CEO Compensation and CEO Trading Profits" Ph.D. Dissertation, The University of Kansas, 1990.
[120] K.J. Hebner & T. Kato, "Insider Trading and Executive Compensation: Evidence from the U.S. and Japan" (1997) 6 International Review of Economics and Finance 223.
[121] Darren T. Roulstone, "The Relation Between Insider-Trading Restrictions and Executive Compensation" (2003) 41 J. of Accounting Research 525.

The Effect of Insider Trading on Securities Prices and Liquidity

One of the other questions that has been examined relatively recently is whether insider trading has an effect on securities prices. Many studies in the past had shown run-ups in prices prior to public disclosures. These run-ups may have been due to insider trading, but they may also have been due to the market anticipating the public announcement of the particular event. A study in 1992 that used U.S. Securities and Exchange Commission data traced the effects of trading by 320 defendants in insider trading cases from 1980-1989.[122] It found that insider trading does have a significant effect on share prices, thereby increasing stock price accuracy. The run-ups in prices prior to public announcements observed were found to be due to insider trading, and insider trading accounted for 40 to 50 percent of the price reaction to public announcements. The study thus tends to confirm the suspicion that run-ups in prices prior to public announcements observed in earlier studies may have been due largely to insider trading. The study also suggested that part of the price increase was due to transmission of private information to the market indirectly through insider trading. It found that factors such as trade size, the number of insider trades, the direction of the trades and the total volume traded by insiders affect the extent to which inside information is incorporated into securities prices. The study is thus consistent with the stock price efficiency benefit of allowing insider trading.

A similar study in 1992 focused on insider trades relating to an announcement of a takeover bid of Campbell Taggert by Anheuser-Busch.[123] It found, consistent with the study referred to above, that insider trading had a significant impact on the share price. It also found that liquidity increased. The presence of insider trading appeared to attract other traders, thus increasing liquidity and keeping bid-ask spreads from increasing. This casts some doubt on the argument that insider trading makes stock prices less efficient by reducing liquidity.

More recently, a study in 2004 found that insider trading accelerates the incorporation of firm-specific information into securities prices.[124] This also supports the argument that insider trading improves the efficiency of securities prices by causing securities prices to reflect information about the securities more quickly than would occur without insider trading.

[122] Lisa K. Meulbroek, "An Empirical Analysis of Illegal Insider Trading" (1992) 47 Journal of Finance 1661.
[123] Bradford Cornell & Erik R. Sirri, "The Reaction of Investors and Stock Prices to Insider Trading" (1992) 47 Journal of Finance 1031.
[124] Joseph D. Piotroski & Darren T. Roulstone, "The Influence of Analysts, Institutional Investors, and Insiders on the Incorporation of Market, Industry, and Firm-Specific Information into Stock Prices" (March 2004 – Available on the Social Science Research Network database).

There have been numerous other studies that have assessed the relationship between insider trading, bid-ask spreads and market liquidity. A recent review of these studies found them to yield inconsistent and inconclusive results and noted that "[t]he adverse selection cost, as well as other costs, must be compared to the benefits of insider trading and the costs of enforcing insider trading regulation."[125]

The Effect of Insider Trading on Securities Values

Another approach that has been taken recently to assessing the effects of insider trading is to examine the effects of the introduction of insider trading prohibitions and the effects of actual enforcement of insider trading prohibitions in several countries. This has become possible with the relatively recent enactment of laws prohibiting insider trading in several countries around the world.[126] A study in 2002 examined the effects of the introduction of insider trading laws in other countries and the effect of subsequent enforcement of those laws on the cost of equity.[127] Reducing the cost of equity reduces the financing cost for an issuer. In addition to encouraging further investment by an issuer, a reduction in the financing costs for an issuer increases the value of the assets of the issuer and the value of its securities. The study found that the effect of the introduction of insider trading laws on the cost of equity was insignificant. However, the effect of the first enforcement of insider trading laws was a significant reduction in the cost of equity. This supports the argument that a prohibition of insider trading, if it is enforced, is beneficial. It also suggests, however, that a prohibition of insider trading that is just "window dressing" (i.e., with no enforcement) is of little or no benefit.[128]

Insider Trading and Agency Costs

A study in 2004 (by Beny) examined insider trading across several countries, focusing on the relationship between insider trading and agency costs.[129] The superior compensation argument is related to the issue

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[125] See Dolgopolov, *supra* note 110 at 175.
[126] See Utpal Bhattacharya & Hazem Daouk, "The World Price of Insider Trading" (2002) 57 Journal of Finance 75. Bhattacharya & Douck looked at 103 countries having stock markets and found 87 of them had insider trading laws and that prosecutions had been taken in 38 of them. According to their study, before 1990 only 34 of the 103 countries had insider trading laws and there were prosecutions in only 9 of those countries.
[127] *Ibid.*, Bhattacharya & Daouk.
[128] But a study of the impact of European insider trading restrictions found little effect on cost of capital, mean returns, or the volatility of securities prices. See Javier Estrada & J. Ignacio Peña, "Empirical Evidence on the Impact of European Insider Trading Regulations" (2002) 20 Stud. Econ. & Fin. 12.
[129] Laura N. Beny, "Do Insider Trading Laws Matter?: Some Preliminary Comparative Evidence" (2005) 7 Am. L. & Econ. Rev. 144.

of agency costs.[130] As noted above, allowing managers to engage in insider trading may compensate them for acting in the interests of investors in ways that other compensation techniques do not. It thus reduces agency costs by better aligning the interests of managers and investors. On the other hand, allowing insider trading may exacerbate agency costs by creating perverse performance incentives, an incentive to engage in overly risky activities to create greater security price volatility, and an incentive to hoard information to the detriment of effective management of the issuer.[131]

The 2004 study looked at the effect of a prohibition of insider trading on the relationship between ownership concentration and agency costs. One technique for reducing agency costs is to have more concentrated ownership (i.e., one, or just a few persons, holding most of the shares).[132] The holders of a significant majority of the shares have more of an incentive to monitor managers carefully and replace them if they do not act effectively in the interests of shareholders. The basis of the study was that there would be less of a need for concentrated ownership to reduce agency costs if permitting insider trading reduced agency costs.[133] Conversely, there would be more of a need for concentrated ownership to reduce agency costs if permitting insider trading increased agency costs.[134] From the perspective of prohibiting insider trading, if prohibiting insider trading reduces agency costs then laws prohibiting insider trading should be associated with lower ownership concentration. If prohibiting insider trading increases agency costs, then a prohibition of insider trading should lead to a greater concentration of ownership.

The study examined ownership concentration and the stringency of insider trading laws in thirty-six countries. It found a statistically significant relationship between ownership concentration and the stringency of insider trading laws. More stringent insider trading laws were associated with lower levels of ownership concentration.[135] This is consistent with the argument that prohibition of insider trading reduces agency costs (or, conversely, that permitting insider trading increases agency costs).

[130] On the agency cost approach to the separation of ownership and control see, e.g., Michael Jensen & William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976), 3 J. of Financial Economics 305; Eugene Fama, "Agency Problems and the Theory of the Firm" (1980) 88 J. of Political Economy 288; Eugene Fama & Michael Jensen, "Separation of Ownership and Control" (1983) 26 J. of Law and Economics 301; Eugene Fama & Michael Jensen, "Agency Problems and Residual Claims" (1983) 26 J. of Law and Economics 327; Frank Easterbrook & Daniel Fischel, "Corporate Control Transactions" (1982) 91 Yale L.J. 698; and Ronald Gilson, *supra* note 104.

[131] See *supra* note 106 on information hoarding.

[132] See, e.g., Harold Demsetz, "Corporate Control, Insider Trading, and Rates of Return," (1986) 76 *American Economic Review* 313.

[133] Beny, *supra* note 129, at 146-48.

[134] *Ibid.*

[135] *Ibid.*, at 161-62, Table 3, and at 173.

If Canada has high ownership concentration, then the study might be said to suggest that our insider trading laws are either weak or are poorly enforced. It should be noted that Canada was one of the thirty-six countries included in the study. The study ranked the stringency of insider trading laws for each country on a scale from one to five, with five being most stringent. Relying on the 2002 study referred to above, the 2004 study also took account of whether or not the laws had ever been enforced as of the date of the study. The frequency of enforcement was not, however, a parameter identified or used in the study. Canada was given a score of 5 – i.e. it ranked, along with the United States, as having the most stringent insider trading laws.[136] The study did not set out the numbers for relative ownership concentrations in the countries studied, so it is not clear from the study whether Canada's degree of ownership concentration was in fact high relative to the other countries studied. While the study provides some evidence in support of the argument that an insider trading prohibition reduces agency costs, it does depend on the strength of the assumed relationship between ownership concentration and agency costs. If there is a reason for high ownership concentration other than the reduction of agency costs, it would mitigate the strength of the evidence for the prohibition of insider trading provided by the study.

Another study in 2004 (by Durney and Nain) that examined the relationship between ownership concentration and insider trading restrictions in 21 countries found that where minority shareholder protections were weak, insider trading restrictions might actually make minority shareholders worse off.[137] Prohibiting insider trading, the authors suggested, led to more covert forms of expropriation of firm resources by controlling shareholders. This created more information asymmetry that encouraged trading by "informed outsiders" (persons who were able to gather information on the expropriation by controlling shareholders).

c) Summary

Several studies over roughly the last fifteen to twenty years have begun to address the empirical questions raised in the debate over the benefits of prohibiting insider trading. Some of the studies lend support to Manne's arguments against the prohibition of insider trading. For instance, some evidence suggests there may also be benefits in the form of reduced costs of executive compensation. Other studies of insider

[136] *Ibid.*, at 150 describing the index under the heading "IT Law"; and at 160, Table scoring Canada and the United States as having the most stringent insider trading laws with a score of 4. For comparison, the insider trading laws of Australia, Hong Kong, Ireland, Singapore, Thailand and the United Kingdom were scored at 3. India, Malaysia and South Africa were scored at 2.

[137] Art Durnev & Amrita S. Nain, "The Unanticipated Effects of Insider Trading Regulation" (May 25, 2004) (available on the Social Science Research Network).

trading in advance of public announcements suggest that insider trading can significantly affect securities prices and thus may move them closer to their underlying values in light of the undisclosed information. The studies, however, on the effect of insider trading on liquidity or bid-ask spreads seem inconsistent. Some recent cross-country comparison studies suggest that there may be overall benefits to the prohibition of insider trading and that a prohibition of insider trading may reduce agency costs. The evidence on the benefits of prohibiting insider trading may, however, be sensitive to other aspects of the particular market as suggested, for instance, by the relationship between minority shareholder protection and the effects of insider trading laws on minority shareholders. But it appears that where protections of minority shareholders are strong, a prohibition of insider trading is more likely to yield net benefits.

iv. A Suggested Alternative Approach

The recent Task Force Report on Insider Trading[138] recommended that consideration be given to adopting an "information connection" approach to insider trading.[139] The current approach is what the Report refers to as a "person-connection" approach in addition to an "information-connection" approach. The "person-connection" approach requires a connection or relationship to the issuer, or the obtaining of information from a person who has such a connection.[140] In provincial securities acts, this person-connection test is captured in the "special relationship" requirement. The "information-connection" approach would simply involve a prohibition of trading by any person who has knowledge of inside information subject to exceptions for persons who reasonably believe the information is generally disclosed, in situations where the information is "readily observable," or where the information is obtained through *bona fide* investigation.[141]

The Task Force Report noted the difficulties involved in obtaining a conviction on an insider trading charge. It recommended an "information-connection" approach to reduce the elements of the offence that the Crown would have to prove in order to obtain a conviction on an insider trading charge. It might also facilitate the imposition of administrative sanctions. This, it was suggested, might increase the likelihood of obtaining a conviction, and thereby create a stronger deterrent to insider trading.

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[138] *Illegal Insider Trading in Canada: Recommendations on Prevention, Detection and Deterrence* (November, 2003) [*Task Force Report*].
[139] *Ibid*., at 37-39.
[140] *Ibid*., at 37.
[141] *Ibid*., at 38-39.

7. Market Manipulation

The integrity of the market and its ability to efficiently allocate capital will be adversely affected if securities market prices are being manipulated. Investors who suspect prices are being manipulated are likely to anticipate that, on average, the manipulators of securities prices will gain at their expense. Investors will want to be compensated for the risk of losses caused by manipulation and will discount securities prices to build in compensation. They may do so across a particular market to the extent they can not identify which securities' prices are likely to be manipulated.

Even where investors are not specifically aware of instances of market manipulation, where market manipulation is present in a particular market the effects of gains by manipulators at the expense of other investors will, over the longer run, affect returns to non-manipulator investors. These investors are likely to eventually adjust their expectations and reduce the prices they are willing to pay for securities in that market.

The more common types of market manipulation involve various "wash sale" techniques,[142] dissemination of false information,[143] scalping,[144] or giving misleading impressions though high-volume

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[142] A "wash sale" is a trade in which there is no change in the beneficial ownership of the security (i.e., the buyer is also the seller, the buyer and seller are acting jointly, or there are several buyers and sellers co-operating so that the securities are eventually bought by the person who initially sold them). If the buyer is the same person as the seller, or if the buyer (or buyers) and seller (or sellers) are acting jointly, then both the price and the volume of the trade can be predetermined. At the time the trade is made the price at which it was made will be reported as the last price at which a trade in the security was made. It will remain the quoted price of the security until a subsequent trade in that security is made. If others are duped into trading at the artificially affected market price those involved in creating the artificial price through the wash sale can gain by selling securities at the artificially high price they have created or by buying securities at an artificially low price they have created.

Wash sales can also be used to create a misleading appearance of trading in a security. It can give investors an impression that there is more trading than there actually is. This may induce investors to purchase the security and to pay too much for the security based on a false impression of the liquidity of their investment in the security or an impression that there is some significant information concerning the security that has caused the high volume of trading.

[143] Persons in a position to disseminate false information (usually, but not always, management of the issuer or other persons with a close connection to the issuer) can gain through subsequent trades at market prices that are artificially high or low due to the false information.

A particular form of disseminating false information has become possible through the Internet. An issuer of securities may maintain a website that may contain false or misleading information. The issuer hasn't formally distributed the information to investors but investors can check the site themselves and may be influenced by the false information. Persons other than the issuer may also be in a position to credibly provide information through the Internet. For instance, rumours might be spread through an Internet bulletin board or chat room. False information may also be spread by the use of an Internet site that uses a site name very similar to the name used by the issuer for its website, or very similar to the name for the website of a well-known and respected securities analyst. Computer hackers may alter information on an issuer's website, or the website of a well-known and respected securities analyst.

trading.[145] Wash sales are prohibited under the *Criminal Code*[146] and could be the basis for penal and administrative sanctions under the securities legislation.[147] Dissemination of false information may be subject to penal sanction under the *Criminal Code*[148] and under securities legislation.[149] It could be subject to administrative sanctions under securities legislation[150] and potential common law and, more

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[144] Scalping is closely related to the dissemination of false information. It involves the purchase of a particular security just prior to touting the security in some form of investment commentary or news media. The security could be sold at the artificially higher price that may prevail as a result of the favourable commentary. Similar gains might be made by short sales in advance of an unfavourable commentary.

[145] It may also be possible for persons who control a large portion of the securities of an issuer to influence the price of the securities by buying or selling the securities in large volumes. For example, a person controlling a large portion of the shares of a particular issuer and seeking to manipulate the share price could begin selling a substantial volume of the issuer's securities. The large volume of sales would tend to drive the price down. Investors might then infer from the falling price that there is some unfavourable information about the issuer. They might then sell shares of the issuer in the expectation of a further decrease in the price of the issuer's shares. At that point, the manipulator could begin purchasing the shares at the low prices that were induced by his initial high volume sales. The manipulator could then continue the purchases in high enough volumes to repeat the process by now causing investors to infer the presence of some favourable information concerning the issuer. Investors would buy the shares of the issuer in the expectation of a further rise in the price and the manipulator would then sell the shares at the inflated price induced by his large volume purchases.

This sort of scheme is not likely to work in a market that is fundamentally efficient (i.e. securities prices track the underlying values of the securities). If sufficient information relating to cash flows and systematic risk is being gathered, assessed and traded on to cause the prices of securities to reflect their underlying values, then attempts by the manipulator to significantly affect prices by high-volume trades will not work. If the manipulator tried to increase the price by high-volume purchases a relatively modest rise in the price may attract a very large number of sellers who, having assessed the value of the security on the basis of its fundamentals, believe the price being offered is more than the security is worth. The manipulator is likely to find himself buying a very large volume of shares at a price that is more than the shares are worth and losing on each such purchase. The upward trend in prices created by the manipulator's purchases may not be interpreted as a sign of undisclosed favourable information. Sophisticated market participants who have gathered a substantial amount of information concerning the issuer are likely to know that the market price is too high relative to the underlying value of the security.

Market manipulation of this sort is more likely to work where there is a relatively low volume of trading in the security. The low volume of trading makes it difficult to recoup costs of gathering extensive information on the fundamentals of the security's value. This may make sophisticated investors reluctant to become involved in following the security, leaving relatively unsophisticated investors trading in the shares. The investors may use securities price and trading volume data as a low cost source of information concerning issuers of securities. In this environment, securities price and trading volume data may be used as a signal of good or bad news concerning the issuer creating potential for a manipulator to influence investors' assessments of the values of securities.

[146] R.S., 1985, c. C-46, s. 382.

[147] See *e.g.* the B.C. *Securities Act*, *supra* note 83, s. 161 allowing the commission or executive director to make various types of orders where they are considered to be "in the public interest". See also the Ontario *Securities Act*, *supra* note 83, s. 127. See also B.C. *Securities Act*, *ibid.*, s. 57.1; and Ontario *Securities Act*, *ibid.*, s. 126.1 which deal with securities market fraud including wash sales.

[148] *Supra* note 146, s. 380.

[149] See *e.g.* the B.C. *Securities Act*, *supra* note 83, s. 168.1(1)(b) which provides that

> "a person must not … make a statement or provide information in any record required to be filed, provided, delivered or sent under this Act or the regulations that, in a material respect and at the time and in light of circumstances under which it is made, is false or misleading, or omit facts from the statement or information necessary to make that statement or information not false or misleading."

See also Ontario *Securities Act*, *supra* note 83, s. 126.2, as amended by S.O. 2002, c. 22, s. 182; and S.O. 2004, c. 31, Sched. 34, s. 4 (1).

[150] See B.C. *Securities Act*, *supra* note 83, s. 162; and Ontario *Securities Act*, *supra* note 83, s. 127 para. 9.

recently, statutory, civil liability sanctions.[151] Scalping may be subject to penal sanction for fraud under the *Criminal Code*[152] and to administrative sanctions under securities legislation.[153] In addition to potential penal sanctions for fraud under the Criminal Code and penal and administrative sanctions under securities acts, escrow requirements on initial offerings of shares by issuers may reduce the potential for manipulation by high-volume trading.

[151] See the Ontario *Securities Act*, *supra* note 83, Part XIII.1. On the common law action for negligent misrepresentation see *Queen v. Cognos* [1993] 1 S.C.R. 87, 99 D.L.R. (4th) 626, 14 C.C.L.T. (2d) 113 (S.C.C.); and see the discussion in Lewis N. Klar, *Tort Law*, 2d ed., (Scarborough, Ont.: Carswell, 2003), at 204-35..
[152] *Supra* note 146, s. 380.
[153] See the provisions cited *supra* note 150.

8. Takeover bid Regulation

i. Reasons for Takeover Bid Regulation

Takeover bid regulation initially responded to concerns raised in the context of hostile takeover bids. The bids tended to be open for only a short period of time. The short bid period had two main advantages for the acquirer: it discouraged competing bids, and it made it difficult for target management to engage in defensive tactics designed to either block the takeover or seek competing bids. All cash offers were typically used to avoid the delay caused by having to clear a prospectus in order to offer shares in a share exchange offer.

Several concerns were noted.[154] For instance, very little information was provided to target shareholders. They often were not even informed of who was making the offer. Target shareholders thus had no information for assessing whether the offer was a good offer, or whether they should: take what was being offered and get rid of their shares; hold on to their shares in the hope of sharing in the gain the offer or expected to generate; hold on to their shares in the hope that the bid would fail and the target management would continue to manage the target; or hold on to the shares in the hope of receiving a subsequent higher offer. This lack of disclosure was said to constitute a "gap" in securities law. If the bid had been in the form of a share exchange offer, a prospectus would have been required and bidders, it was argued, should not be able to avoid disclosure simply by making a cash offer.

The short bid period gave target shareholders very little time to respond. If more information was to be provided, then target shareholders would need more time to assess the information.

Bids for less than all the shares tended to be made on a "first-come, first-served" basis. This put additional pressure on shareholders to tender early to avoid being left out of a bid and to avoid being minority shareholders in the newly acquired target company. If shareholders were to be given time to assess the information that should be provided to them, then first-come first-served bids for less than all the shares would have to be prevented since it would defeat the purpose of giving target shareholders additional time to assess the bid.

Once shares were tendered in response to an offer, the contractual agreement of the target shareholder to

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[154] *Kimber Report*, *supra* note 1 at paras. 3.01 to 3.25. See also U.S.C. Congressional and Administrative News, 1968, p. 2811; House Report No. 1711, July 15, 1968.

sell the shares was complete. The shares were thus no longer available for tender under a subsequent bid and were said to be "locked up". This tended to discourage competing bids, since by the time competing bidders were prepared to make a bid, the majority of the shares might have already been locked up by the first bidder.

There were also various concerns about unequal consideration being paid. Initial bids might be made at a relatively low premium above the pre-bid market price, followed by subsequent bids at slightly higher premiums above the pre-bid market price. Target shareholders who tendered under the early bid would only be paid the early bid price. Shareholders who tendered under later higher bids were paid the higher bid prices. This was perceived as being unfair to shareholders who tendered under the earlier bid. Another unequal consideration concern was that the bidder might seek the shares of a controlling shareholder or a group of persons jointly controlling the corporation, rather than making a bid to all shareholders. The controlling shareholder or group might then obtain a premium for their shares while the remaining shareholders were left with no premium at all. It was argued that this was unfair to the shareholders to whom offers were not made.

One of the main concerns expressed early on was that takeover bidders were looting targets. One form of this looting concern was corporate pillars of society were being taken over and destroyed by the winding up of these corporations.[155] Another looting concern was that bidders might acquire less than all the shares of the target and then, using the control position obtained thereby, force minority shareholders to sell their shares at less-than-fair market value in a post-takeover amalgamation. Otherwise, bidders who acquired a majority stake in targets might take advantage of minority shareholders by allocating corporate opportunities to the bidder corporation or its wholly owned subsidiaries, or by selling assets of the target at less-than-fair market value to entities related to the bidder.

Other concerns included a concern that bidders might be forced to renege on their bids not having obtained sufficient financing to pay for the shares. In setting out their bids, they might also leave themselves with considerably flexibility as to whether or not they were obliged to take up shares tendered, and might give themselves prolonged periods of time to take up shares and to pay for shares tendered and taken up under the bid. Bidders might also buy or sell shares during bid period, affecting the likelihood

[155] See the comments of Senator Williams, 11 Cong. Rec. 27248-49, October 22, 1965. The winding-up of a corporation may, however, make economic sense where its business is no longer generating sufficient returns to compensate for the systematic risk associated with investment in the business, or where the assets of the business might be more highly valued in some other investment that current management is unwilling to direct the assets to (perhaps because it involves an area of business that is beyond their expertise).

of the success of the bid. The change in the likelihood of the success of the bid would affect a target shareholder's decision on whether to tender under the bid or not. Concerns were also raised about bidders taking shares tendered under their bids and then abandoning their bids. This left the shareholders whose shares were taken up unable to tender under a competing bid.

The concerns noted above that led to takeover bid regulation can be linked to the notion of confidence in the market. Investors may be concerned that should a takeover bid be made for shares they hold, they will lack the information they will need to assess whether to tender under the bid and they will lack the time to properly assess whether to tender. They may fear that if a bid is made and they tender their shares, the shares may become locked up so that they will be unable to tender under subsequent higher bids by the same bidder or under competing bids. They may be concerned about the possibility that shares they tender will not be paid for in a timely manner or paid at all. They may be concerned that control will change hands without them being able to share in the control premium. If these concerns are taken into account when investors initially acquire shares, then they may be inclined to reduce the price they pay for the shares. This discounting of the prices for shares (or other securities) would result in reduced allocations of savings to investment, higher financing costs and a related reduction in economic growth. The role of takeover bid regulation is arguably to address these concerns, thereby promoting confidence in the market and reducing the incentive of investors to discount the prices they pay for shares.

ii. The Takeover Bid Regulation Policy Debate

Arguments have, however, been made against takeover bid regulation. These arguments suggest that rather than increasing securities values (and making the market more competitive) takeover bid regulation reduces securities values (making the market less competitive).

a) The Arguments Against Takeover Bid Regulation

There are several possible motivations for takeovers, some of which may be socially beneficial. For instance, a takeover that replaces an inefficient management team with a more efficient management team will increase the value of the issuer and therefore increase the value of its securities, making investors better off. Takeovers that produce synergistic gains also increase the value of the assets that are combined in a synergistic way. This too can increase the value of the securities associated with the combined assets and thereby make investors better off.

A takeover bid may be a particularly effective technique for the replacement of a relatively inefficient management team. A management that faces replacement upon a takeover is unlikely to co-operate in a merger proposal that removes them from their management positions. Proxy contests have not generally been a particularly effective technique for replacing an issuer's management team where the issuer's shares are widely held.[156] A takeover bid allows a bidder to obtain sufficient control to replace an existing management without engaging in a proxy contest or seeking co-operation from the existing management. The threat that a management team may be replaced through a takeover bid may encourage the management team to be more efficient and to take steps to reduce agency costs.[157] Takeover bid regulation, it is argued, tends to deter takeover bids and thus discourages takeovers that replace inefficient management. It also reduces the threat of a takeover, thereby giving greater room for management teams to behave efficiently and contrary to the interests of investors (i.e., increasing agency costs).[158]

Takeover bid regulation may deter takeovers in several ways. For instance, the disclosure requirements may give competing bidders useful information in formulating competing bids. The minimum bid period allows time for competing bidders to gather and assess information concerning the target and prepare a competing bid. It gives targets time to engage in defensive tactics that further encourage competing bids. The pro rata take-up requirement and withdrawal rights make shares available for tender under competing bids. Increased potential for competing bids reduces the potential gains to bidders from making an initial takeover bid.[159] Competing bidders have an advantage over the first bidder since they do not incur the costs associated with identifying the potential target – the first bidder does this for them. Competing bidders are thus likely to be able to outbid the first bidder since, unlike the first bidder, they do not have to recoup the information costs associated with identifying the potential target. There may thus be little incentive to be a first bidder. The shares a first bidder can acquire before announcing a takeover bid allows the bidder at least some gain from being the first bidder since, if they are unable to acquire the target themselves, they could at least tender their shares under a subsequent competing bid. Takeover bid regulation also deters this potential gain to a bidder by restricting tenders of shares under other bids.

[156] See, for example, Daniel R. Fischel, "Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers" (1978) 57 Tex. L. Rev. 1, at 6.
[157] See R. Grabowski, I. Mathur & N. Rangan, "The Role of Takeovers in Increasing Efficiency" (1995) 16(3) Managerial and Dec. Economics 211 for evidence in support of the claim that the threat of takeover makes managements more efficient.
[158] The main proponents of these arguments against takeover bid regulation and target defensive tactics are Easterbrook and Fischel. See, for example, Daniel R. Fischel, "Efficient Capital Market Theory, the Market for Corporate Control, and the Regulation of Cash Tender Offers" (1978) 57 Tex. L. Rev. 1; Frank H. Easterbrook and Daniel R. Fischel, "The Proper Role of a Target's Management in Responding to a Tender Offer" (1981) 94 Harv. L. Rev. 1161. See also Alan Schwartz, "Search Theory and the Tender Offer Auction" (1986) 2 J.L. Eco. & Org. 2; and Henry Manne, "Mergers and the Market for Corporate Control" (1965) 73 J. of Pol. Econ. 110.
[159] See Easterbrook and Fischel, *ibid.* at 1175-76.

Empirical evidence lends support to this alleged deterrent effect of takeover bid regulation.[160] The introduction of takeover bid regulation led to an increase in takeover bid premiums.[161] It also led to increased returns to targets and reduced returns to bidders.[162] Litigation initiated by targets during the minimum bid period delayed takeovers and encouraged competitive bidding.[163] There is evidence that increased competitive bidding led to reduced shareholder wealth for the shareholders of bidding firms.[164] The introduction of takeover bid regulation led to significant decreases in value for firms with announced acquisition programs.[165] It also appears to have reduced takeovers as an acquisition technique.[166]

b) Responses to Arguments Against Takeover Bid Regulation

There have been several responses to the argument that takeover bid regulation reduces share values rather than increasing them. It has, for instance, been argued that takeovers may be motivated by gains to bidders that do not produce corresponding social gains. For instance, bidders may gain simply because

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[160] There is a considerable volume of empirical evidence on takeovers. There are also several reviews of the empirical evidence with respect to takeovers. For reviews of the empirical evidence on takeovers, see Greg A. Jarrell, James A. Brickley and Jeffry M. Netter, "The Market for Corporate Control: The Empirical Evidence Since 1980" (1988) 2 J. of Eco. Perspectives 49; Roberta Romano, "A Guide to Takeovers: Theory, Evidence and Regulation" (1992) 9 Yale J. on Reg. 119 and Ronald J. Daniels, "Stakeholders and Takeovers: Can Contractarianism be Compassionate" (1993) 43 U. of T. L.J. 315. See also B. Espen Eckbo, "Mergers and the Market for Corporate Control: the Canadian Evidence" (1986) 19 Can. J. of Eco. 236; and Michael C. Jensen and Richard S. Ruback, "The Market for Corporate Control: the Scientific Evidence" (1983) 11 J. of Fin. Eco. 5.

[161] See Romano, *ibid.* at 158 citing Michael Bradley, Anand Desai and E. Han Kim, "The Rationale Behind Interfirm Tender Offers: Information or Synergy?" (1983) 11 J. of Fin. Eco. 183; G.A. Jarrell and M. Bradley, "The Economic Effects of Federal and State Regulation of Cash Tender Offers" (1980) 23 J. of Law and Eco. 371, at 389-90; and Greg Jarrell, "The Wealth Effects of Litigation by Targets: Do Interests Diverge in a Merge?" (1985) 28 J. of L. and Eco. 151. But see Kevin Nathan and Terrence O'Keefe, "The Rise in Takeover Premiums: An Exploratory Study" (1989) 23 J. of Fin. Eco. 101 suggesting the increase did not occur until several years after the introduction of the *Williams Act*; and Julian Franks and Robert Harris, "Shareholder Wealth Effects of Corporate Takeovers: The U.K. Experience 1955-1985" (1989) 23 J. of Fin. Eco. 225 finding that takeover premiums also increased in the U.K.

[162] See *e.g.* R. Smiley, "The Effect of the Williams Act and Other Factors on Transactions Costs in Tender Offers" (1975) 3 Ind. Org. Rev. 138; Jarrell and Bradley, *ibid.* at 387-98; and Paul Asquith, Robert F. Brunner and David Mullins, Jr., "The Gains to Bidding Firms from Merger" (1983) 11 J. of Fin. Eco. 121, at 133 and 138.

[163] See Jarrell, *supra* note 161.

[164] There is evidence that increased competition in takeover contests, which may result from takeover bid regulation, reduces shareholder wealth — see S. De, M. Fedenia & A.S. Triantis, "Effects of Competition on Bidder-Returns" (1996) 2(3) J. of Corp. Fin. 261. There is also evidence that a competitive bid from a "white knight" is met with an immediate and strongly negative market reaction concerning the first bidder's shares — see A. Banerjee & J.E. Owers, "The Impact of the Nature and Sequence of Multiple Bids in Corporate Control Contests" (1996) 3(1) J. of Corp. Fin. 23.

[165] K. Schipper & R. Thompson, "The Impact of Merger-Related Regulations on the Shareholders of Acquiring Firms" (1983) 21 J. of Accting. Res. 184; and K. Schipper and R. Thompson, "Evidence of the Capitalized Value of Merger Activity for Acquiring Firms" (1983) 11 J. of Fin. Eco. 85.

[166] See Jarrell and Bradley, *supra* note 161.

target shares are undervalued.[167] They may gain from reduced competition.[168] Activities of acquiring firms may just represent an agency cost in which the managers of the acquiring firms seek diversification of their firm's investments. This would reduce the risks that bankruptcy might impose on the managers, but would not benefit the shareholders who can obtain the benefits of such diversification themselves by

[167] Takeover bids may simply be done to acquire the shares of targets that are undervalued in the market. This may provide a social benefit to the extent it causes the market price to better reflect the value of the target's shares, thereby improving the efficiency of allocation of financial resources. But the social gain may not be as great as the gain to the bidder from acquiring the undervalued shares. This may cause bidders to engage in takeover bids to an extent that is not justified by the social gains from better pricing of target shares. See *e.g.* L.A. Bebchuk, "The Case for Facilitating Competing Tender Offers" (1982) 95 Harv. L. Rev. 1028 ["Facilitating Competing Tender Offers"] at 1047. See also the discussion in Romano, *supra* note 160, at 143-45.

Securities prices may need to deviate significantly from their underlying values to justify takeover premiums in the order of 30 to 50%. This would suggest a very significant degree of securities market inefficiency. If undervaluations were the cause of a substantial number of takeovers, one would expect to find that even where targets were not acquired, their share prices would remain at a higher level after a failed takeover bid that revealed that the shares were undervalued. Studies show, however, that target share prices fall to their pre-bid levels after an unsuccessful takeover bid. See Romano, *supra* note 160, at 144 citing Paul Asquith, "Merger Bids, Uncertainty and Shareholder Returns" (1983) 11 J. of Fin. Eco. 51; Bradley, Desai and Kim, *supra* note 161; and Jarrell, *supra* note 161.

It has been argued that the market does not fully reflect the value of long-term investments target that management may be pursuing because the market tends to focus on short-term gains. Bidders might thus gain by acquiring a target and shifting its investments to short-term investments. See, e.g., Romano, *supra* note 160, at 144-45; and Jeremy Stein, "Takeover Threats and Managerial Myopia" (1988) 96 J. of Pol. Econ. 61. The evidence may not support this potential undervaluation of long-term investments. Targets tend to be in industries with low investments in long-term research and development. The research and development activities of target firms and acquirer firms are not significantly different. Post-acquisition research and development expenditures either increase or remain unchanged. See Romano, *supra* note 160, at 145 citing B. Hall, "The Effect of Takeover Activity on Corporate Research and Development" in A. Auerbach, ed., *Corporate Takeovers: Causes and Consequences* (Chicago: University of Chicago Press, 1988) 69. The market also tends to respond favourably to capital expenditures and announced increases in research and development expenditures. See Romano, *supra* note 160, at 145, citing S.H. Chan, J. Martin and J. Kensinger, "Corporate Research and Development Expenditures and Share Value" (1990) 26 J. of Fin. Eco. 255; and J. McConnell and C. Muscarella, "Capital Expenditure Decisions and Market Value of the Firm" (1985) 14 J. of Fin. Eco. 399.

[168] Reduced competition leads to net social efficiency losses. Takeover bid regulation can be beneficial to the extent it deters such takeovers. See, e.g., Bebchuk, "Facilitating Competing Tender Offers", *ibid.* at 1047; see also Romano, *supra* note 160, at 142-43. If competition in an industry is reduced, it should result in increased share prices for firms in the industry generally. Studies of the share prices of competitors of acquirers and targets, however, have not shown increased prices due to takeovers reducing competition. See B. Espen Eckbo, "Horizontal Mergers, Collusion and Stockholder Wealth" (1983) 11 J. of Fin. Eco. 241; B. Espen Eckbo, "Mergers and the Market Concentration Doctrine: Evidence from the Capital Market" (1985) 58 J. Bus. 325; and R.S. Stillman, "Examining Antitrust Policy Towards Horizontal Mergers" (1983) 11 J. of Fin. Eco. 225. The takeovers analyzed in these studies thus appear to have been motivated by gains other than those from reduced competition. Sales margins also do not appear to increase in related industry takeovers. See Romano, *supra* note 160, at 143, citing P. Healey, K. Palepu and R. Ruback, "Does Corporate Performance Improve After Mergers?" National Bureau of Economic Research Working Paper No. 3348.

holding diversified portfolios.[169] Some takeovers may occur simply because the bidder has come to a mistaken belief that there are gains to be made from a particular takeover.[170] The gains may also arise from the expropriation of wealth from other stakeholders such as taxpayers,[171] target employees,[172]

[169] See Bebchuk, "Facilitating Competing Tender Offers", *supra* note 167, at 1047; R. Marris, "A Model of the 'Managerial' Enterprise" (1963) 77 Q. Journal of Eco. 185. There may be benefits from diversification by managers since it may relieve stress to managers from the threat of bankruptcy and the consequent loss of their jobs. In exchange, managers may accept lower compensation thus benefiting investors. It may also protect managerial human capital from being dissipated in the event of bankruptcy and thus give managers a greater incentive to build human capital necessary to the efficient management of the firm, thereby also benefiting investors. There may thus be net gains to investors from management created diversification. See Romano, *supra* note 160, at 147.

There is empirical evidence indicating that acquirer returns are higher where acquirer management's share ownership is higher, and acquirer returns are lower where acquirer management share ownership is low. Where acquirer management share ownership is low, management incentive to act in the interests of shareholders is weakest. See Romano, *supra* note 160, at 149, citing W. Lewellen, C. Loderer and A. Rosenfeld, "Merger Decisions and Executive Stock Ownership in Acquiring Firms" (1985) 7 J. of Accting & Eco. 209. The evidence also suggests that acquirer returns are lower the less independent (or more management controlled) the acquirer's board is. See Romano, *supra* note 160, at 149, citing J. Bird and R. Hickman, "Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids" (manuscript, Washington State University); and see Z.Z. Zantout & M. O'Reilly-Allen, "Determinants of Corporate Strategy and Gains of Acquiring Firms" (1996) 11(1) J. of Accounting, Auditing & Finance 119 (finding that the probability of engaging in a diversification program decreases when the board of directors is dominated by outsiders). This indicates that where managers are not as well monitored by independent directors they may be more inclined to engage in less beneficial takeovers. The evidence is thus consistent with a degree of acquirer management self-interest in the motivation for takeovers.

[170] On this "hubris" hypothesis, see Richard Roll, "The Hubris Hypothesis of Corporate Takeovers" (1986) 59 J. Bus. 197. There is some support for this hypothesis in evidence of negative returns to bidders in the 1980s. See *e.g.* Michael Bradley, Anand Desai and E. Han Kim, "Synergistic Gains from Corporate Acquisitions and Their Division Between the Stockholders of Target and Acquiring Firms" (1988) 21 J. of Fin. Eco. 3; and Jarrell, Brickley and Netter, *supra* note 160, at 53. Bidders also appear to overpay in takeovers. See, for example, N. Varaiya, "The 'Winners Curse' Hypothesis and Corporate Takeovers" (1988) 9 Managerial and Dec. Eco. 209. However, when bidder losses are combined with target gains there are overall net gains from takeovers. This suggests that the "hubris" hypothesis does not explain all takeovers. See Bradley, Desai and Kim, *ibid.*

[171] Tax gains may, for example, arise from combining a corporation with losses or depreciation allowances with another corporation that has profits against which the losses may be applied.

[172] A bidder may opportunistically break implicit contracts with labour. These implicit contracts may involve such things as dismissals or layoffs of employees or reversions of pension surpluses that target management may be unwilling to undertake given their long-standing relationship with the employees. See Romano, *supra* note 160, at 137-42; and Daniels, *supra* note 160, at 318-21.

creditors,[173] customers,[174] or minority shareholders.[175] While the available empirical evidence provides some support for these other explanations of takeovers, it falls well short of explaining all of the apparent overall gains from takeovers.[176]

It has also been argued that by promoting competing bids, takeover bid regulation encourages the allocation of assets to their most highly valued use.[177] It may also encourage initial investments in potential targets, encourage target managers to search for acquirers, and encourage useful exchanges of information by encouraging negotiated amalgamations rather than non-negotiated takeover bids.[178]

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[173] The acquirer may take on increased debt to finance the takeover bid. The increased debt increases the risk of bankruptcy for the acquirer thereby increasing the risk for pre-existing debt. This lowers the value of the existing debt. See Romano, *supra* note 160, at 136-37. See also Daniels, *supra* note 160, at 323-24.

[174] The expropriation from customers may come in the form of reduced competition. See *supra* note 168 on the effect of takeover bids on competition.

[175] Expropriation from minority shareholders may come looting transactions such as post-takeover amalgamations or reorganizations that force out minority shareholders at unfair prices or other transactions in which successful bidders might be able to engage in transactions that benefit the bidder at the expense of the target's minority shareholders. Concerns of this sort are noted in, e.g., V. Brudney and M.A. Chirelstein, "Fair Shares in Corporate Mergers and Takeovers" (1974) 88 Harv. L. Rev. 297, at 336-37; and E.F. Greene and J.J. Junewicz, "A Reappraisal of Current Regulation of Mergers and Acquisitions" (1984) 132 U. Pa. L. Rev. 647, at 676-81.

Target shareholders may be pressured into accepting the bid not because the bid price is reasonable, but because they do not want to be left out of the bid and be subject to a post-takeover force-out at an unfair price. See, e.g., and L.A. Bebchuk, "Toward Undistorted Choice and Equal Treatment in Corporate Takeovers" (1985) 98 Harv. L. Rev. 1693 at 1717-33; and W.J. Carney, "Shareholder Coordination Costs, Shark Repellents and Takeout Mergers: The Case Against Fiduciary Duties" [1983] Am. Bar Found. Res. J. 341.

On these expropriation theories generally see Romano, *supra* note 160, at 133-52; and Daniels, *supra* note 160, at 317-25.

[176] See generally the discussion in Romano, *supra* note 160, and, in particular, the summary of the evidence provided at 152-55.

[177] See, for example, Bebchuk, "Facilitating Competing Tender Offers", *supra* note 167, at 1048 and Gilson, *supra* note 104, at 872.

[178] See Bebchuk, "Facilitating Competing Tender Offers", *supra* note 167, at 1049-50; and R. Lüttman, "Changes of Corporate Control and Mandatory Bids" (1992) 12 Int'l Rev. of Law & Econ. 497. There is competing evidence on whether target management defensive tactics benefit target shareholders. See, e.g., S. Thosar, "Tender Offers and Target Management Responses: Managerial Entrenchment versus Stockholder Interest Revisited" (1996) 31 Fin. Rev. 87 suggesting significantly higher post-tender offer gains where target management resists a takeover. But see J. Saint-Pierre, J.M Gagnon & J. Saint-Pierre, "Concentration of Voting Rights and Board Resistance to Takeover Bids" (1996) 3 J. of Corp. Fin. 45, a study using Canadian data, finding poor target performance and blocks of shares held by directors associated with a higher probability of target management resistance as evidence of managerial entrenchment.

9. Securities Industry Regulation

i. Problems in the Securities Industry Context

Regulation of the securities industry has been said to respond to concerns for the financial responsibility, honesty, and professional competence of securities industry participants. Securities industry participants need to be financially responsible to protect investors who can become unsecured creditors of securities industry participants in securities transactions, and to assure investors that securities transactions will be honoured. This, as noted in Part 4, above, can reduce the risk to investors of non-performance and reduce the costs that investors might otherwise incur in assessing the risk of non-performance.

Securities industry participants may have conflicts of interest.[179] Many of these conflicts of interest arise where the securities industry participant is a firm that offers a wide range of services.[180] The potential for

[179] These conflicts may include, for instance, "churning" (excessive trading for a client's account), and front-running (the execution of an order by a broker on its own behalf before executing a large order from a client or a large number of orders from several clients). The fees from conducting trades on behalf of investors may create an incentive to use various tactics to pressure investors into trades that may not be in the best interests of the investors. Investment advisers may be affected by fees or other benefits they might obtain from issuers of securities. This may have been the case with various incentive techniques provided by mutual funds. See Glorianne Stromberg, *Regulatory Strategies for the Mid-90's: Recommendations for Regulating Investment Funds in Canada* (Prepared for the Canadian Securities Administrators, Toronto, January, 1995) ["Stromberg Report"].

[180] For instance, one department providing underwriting services may have just done a bought deal for the securities of a particular issuer. It will then be important for the firm to sell these securities and, preferably, sell them at a price above that which they paid to the issuer. Pressure may then be brought to bear on the department of the firm providing investment advice to promote the purchase of these securities. Individual clients may be advised to buy the securities even where it is not in their interests to buy the securities. Market commentaries may promote the securities and do so in a way that is disproportionate to the merit of investment in the securities. Portfolio managers may feel pressure from within the firm to purchase the securities for the portfolios they manage even though the securities may not be the best purchase for those portfolios. On the potential conflicts related to market commentaries see *e.g.* John Zych, "The Legal Regulation of Securities Analysts After the Stock Market Bubble" in Poonam Puri & Jeffrey Larsen, *Corporate Governance and Securities Regulation in the 21st Century* (Markham, Ont.: Butterworths Canada, 2004) 141.

Securities firms are now often connected with firms that provide other financial services such as banking or insurance. This can increase the scope for conflicts of interest. For example, a related banking institution may have provided substantial loans to a particular issuer that is now in financial difficulties. The risk that the loans will go unpaid has thus substantially increased. The related entity engaging in underwriting may be encouraged by the banking entity to recommend to the issuer that it make a large public issue of securities. The real purpose for the public offering is to pay down the bank loan to reduce the risk of default on the loan. The underwriter may then provide a less-than-ideal check on the accuracy of the issuer's disclosures and may put the weight of its reputation behind the issue of securities in the hope of raising sufficient funds to get the bank loan paid off. The marketing and investment advice departments of the securities firm engaged in the underwriting may also be pressured to sell the issue to clients by recommending the purchase of the securities by their clients and having portfolio managers purchase the securities for the portfolios they manage.

Securities firms may also apprised of inside information, perhaps in the course of providing financial advice to issuers, while assisting issuers of securities in the preparation of a prospectus, or in the course of providing advice relating to takeover or merger transactions. They may also become apprised of inside information through losses to investors associated with these conflicts of interest may cause investors to discount the prices of securities.

Investors need some assurance that, for instance, persons trading on their behalf know something about how to properly execute a trade, or that persons providing investment advice or managing an investor's portfolio know what they are doing. Without a system to provide some degree of assurance of the professional competence of securities industry participants, investors would need to incur costs to make assessments of competence. At some point, the marginal costs of such assessments would outweigh the marginal benefit and investors would be left with a residual risk of loss associated with improperly provided services. Investors would be inclined to build in compensation for these costs and residual risk of loss by lowering the prices they are willing to pay for securities. Securities regulation that provides some degree of assurance of professional competence of persons providing securities market services can reduce this tendency of investors to discount securities prices.

Professional competence may also be important to assuring the financial competence of firms providing securities industry services. To reduce the risk of securities firm bankruptcies, the persons managing such firms should arguably meet a minimum standard of professional competence for the running of securities firms and the provision of securities industry services. This should reduce the number of bankruptcies that arise due to the inability of securities firm managers to properly run a securities firm, and thereby reduce the risk of non-performance, or non-compensation for non-performance, of securities transactions.

Each of these broad areas of concern for securities industry participants (financial responsibility, honesty, and professional competence) relates to the competitive capital market attributes of confidence in the market, liquidity and the performance of securities transactions. Addressing concerns for investors in each of these areas can reduce their tendency to discount the prices of securities. Reduced risks of loss in securities trading can also make investors more willing to trade, thereby increasing market liquidity.

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financial services (such as banking and insurance) provided to issuers by related financial institutions. Insider trading provisions will normally address trading on this information, or informing others of the information. However, securities firms will face a conflict of interest in servicing their other clients. For instance, if in the course of providing services to an issuer of securities they discover some bad news concerning the issuer it would be in the best interests of their investor clients not to buy those securities and perhaps also sell those securities. Should the underwriting or banking arm of the business advise portfolio managers not to buy those securities, to sell any of those securities they currently hold, sell short, or buy a put option for those securities? Should the underwriting or banking arm of the business advise those providing investment advice to discourage the purchase of those securities or recommend the sale of those securities? Doing so might be in the best interests of their investor clients but not in the best interests of their issuer client. Not doing so would be in the best interests of their issuer client, but not in the best interests of their investor clients.

ii. The Role of Securities Regulation

The confidence in the market problem in the securities industry participant context can be analyzed, at least in part, as an adverse selection problem, much as the mandatory disclosure issue was in Part 5, above. Securities industry participants could take steps to effectively signal their financial competence, honesty and professional competence. These steps would involve costs. At some point, the marginal costs of these efforts will outweigh the marginal gains. Securities regulation could perform an important role in this context if it could reduce the costs of signalling the financial competence, honesty or professional integrity of securities industry participants.

Securities regulation may perform a useful role in way that is similar to the role it may serve in the context of issuer disclosure. It may do this by providing economies in enforcement and modes of enforcement that may not be achieved in private market transactions. It may thus provide a less costly (through reduced costs of enforcement) and clearer signal (through better enforcement mechanisms) than securities industry market participants could provide themselves.

The primary technique used in providing the signal in the context of securities industry participants is by requiring them to be licensed. The acquisition of the license requires some demonstration of professional competence through the completion of required courses and apprenticeship requirements. Failure to obtain a license before engaging in the securities industry services can lead to penal sanction. This deters incompetent service-providers from passing themselves off as competent service providers. Were it not for securities regulation of this sort, competent service providers would likely have to incur significant costs to differentiate themselves from incompetent services providers. It also reduces the need for investors to make their own assessments of the professional competence of persons providing securities industry services.

The granting of a license to a securities firm requires that it meet minimum capital requirements, potential posting of a bond, and contribution to a contingency fund. This provides some protection against financial failures of securities firms that could lead to the non-performance of securities transactions, or the failure to compensate investors for the non-performance of securities transactions. Were it not for securities regulation of this sort, financially competent securities industry firms would have to incur potentially significant costs convincing potential clients of their financial competence. They would also probably have to incur significant costs to assure that other firms they dealt with were financially competent. Investors would have to incur costs to assess the financial competence of the firms whose services they engaged and would likely be left with a significantly higher degree of residual risk associated with potential financial failures of securities industry firms.

The threat of removal of the license can provide an incentive to securities firms and individual securities industry participants to comply with requirements concerning conflicts of interest. Potential penal sanctions may discourage more extreme manifestations of conflicts of interest (particularly where they could be said to constitute fraud) in a way that provides assurances to investors that securities firms and individual securities industry participants could not.

Regulation of the securities industry, as in other areas of securities regulation, can cause increases in the transactions costs associated with complying with licensing requirements, reporting requirements and conflict of interest restrictions. These costs tend to impede competitive capital markets unless there are compensating benefits from the regulation. If the benefits can be obtained with lower transactions costs, the competitiveness of the capital market should improve.

If there is a role for securities regulation in the sense described above, then the question is, as in other areas of securities regulation, whether the benefits can be obtained at less cost. Can, for instance, the same benefits be achieved with fewer of the requirements and thereby reduce compliance costs (and thus transactions costs)? Can the costs of existing types of enforcement be reduced? Is there an enforcement technique that is less costly or that better facilitates the role of securities regulation so that there is a better ratio of benefits to costs in terms of improving the competitiveness of the capital market?

10. Suggestions for Improving the Competitiveness of Canadian Capital Markets

i. Constraints and Path Dependence in the International Context

While there many differences in the details of different securities regulatory regimes around the world, many jurisdictions share similar general approaches to securities regulation. For instance, mandatory disclosure is common with both prospectus requirements and continuous disclosure requirements. There are similar takeover bid regimes in many jurisdictions. There are differences in detail, such as the way the triggering requirement for a takeover bid works, the minimum bid period, the details of disclosure in a takeover bid circular (or similar disclosure vehicle), whether they allow bids for less than all the shares, and so on. However, they typically share features such as disclosure by the bidder, disclosure by target management, a minimum bid period, withdrawal rights and other features. While insider trading restrictions are a relatively recent phenomenon in many jurisdictions around the world, they are becoming more prevalent and often take the form of setting out a detailed definition of the persons subject to the requirements. It is common to regulate securities industry participants with a licensing requirement that provides the threat of administrative sanction in the form of suspension or removal of the license for non-compliance with particular requirements. Minimum capital and contingency fund requirements are also fairly common.

One might contemplate very fundamental changes to securities regulation, such as the issuer-choice or investor regulation approach noted in Part 5, iv, above. There may be fundamental changes that might, in theory, and perhaps in time, lead to significant improvements in several or all of the attributes of a competitive capital market, but these changes may be difficult to implement in the context of international capital markets.

For domestic issuers and investors, there would be the cost of becoming informed of the fundamentally different securities regulatory regime and, even once they became familiar with the new regime, there would be uncertainty about the effect the new regime would have. Would transactions costs and information costs really be lower? Would confidence in the market really be improved? Could investors have the same confidence in the performance of securities transactions or compensation for non-performance? The initial costs and uncertainty might cause many issuers to raise capital in foreign jurisdictions with securities regulatory requirements that are similar to those they were familiar with under the prior regulatory regime in Canada. Investors, too, may prefer to invest in foreign jurisdictions with securities regulatory requirements similar to what they have been familiar with in Canada and under which they may feel more confident than under a new and untried domestic regulatory regime.

For foreign issuers and investors, there will be the cost of learning a different Canadian system - a cost that may not seem justified in light of the range of investment choices from competing jurisdictions. Then there will be the uncertainty associated with the Canadian system, and the cost of compliance with that system. Foreign investors may have the same concerns as Canadian investors considering investing outside Canada, regarding the cost of assessing how the different system works and the uncertainty as to how the new system will work out in practice.

With similarities in approaches to securities regulation in many major capital markets around the world, and with the degree of internationalization of securities markets that has become prevalent in recent years, it would be difficult for any jurisdiction to radically change its securities regulatory regime without risking a significant loss of both issuers who may prefer to raise capital in other jurisdictions and investors who may prefer to invest in other jurisdictions. Thus, there may now be a degree of path-dependence in securities regulation around the world. We may no longer be able to realistically get to radically different securities regulatory regimes even where those regimes might indeed, in the long run, prove to be significantly better.

So what we need to seek is a competitive advantage within the same basic regulatory approach. Instead of, for instance, abandoning mandatory disclosure in favour of some other approach (e.g., investor regulation), we need to tweak the existing regime to reduce transactions costs (or compliance costs) and to see if information costs can be reduced by, perhaps, paring down the amount of disclosure or working with the presentation of disclosure to make it easier for investors to find, assess and compare the relevant information. Improvements in administration and enforcement of securities regulation may be another important source of potential competitive advantage. Is there a way, for instance, to get better compliance for less cost? Can efficiencies be found in the administrative apparatus for the enforcement of securities laws?

Recommendation #1: Avoid changes to Canadian securities regulation that would make it deviate significantly from approaches taken in other major capital markets.

ii. Reform Suggestions

a) Disclosure

Integrated Disclosure

Securities regulation in Canada, and elsewhere, has historically maintained a separation between the disclosure required on a distribution of securities and the "continuous" disclosure an issuer is required to provide once it has made a distribution of securities under a prospectus. A prospectus is provided on a public offering. The information in the prospectus is updated by continuous disclosure requirements that update information concerning the business of the issuer. Responding to a need for quicker access to Canadian capital markets, in the 1980s Canadian Securities Administrators developed first a prompt-offering system and, later, a shelf-offering system for prospectus offerings in certain circumstances. These alternative prospectus offering procedures allow an issuer to incorporate its existing continuous disclosure by reference into a shorter form of prospectus. An "annual information form" (or "AIF") was added to the list of required continuous disclosure documents for issuers that wanted to use these alternative prospectus procedures. The AIF provides an annually updated base of information concerning the issuer and its business. The short form prospectus can then focus primarily on information relating to a particular distribution and the securities offered under that distribution. These systems thus provide for a partial integration of prospectus disclosure and continuous disclosure. This reduces the size of the prospectus that allows, at least in theory, for a quicker vetting of the prospectus by securities regulators. Use of the prompt- and shelf-offering systems is limited primarily to reporting issuers with substantial market values of equity securities available for trading, or to debt or preferred shares with an approved rating or guaranteed by an issuer having a substantial market value of equity available for trading or outstanding approved rating debt or preferred shares. Thus many issuers are not eligible to use these alternative prospectus procedures.

When the prompt- and shelf-offering systems were introduced, the System for Electronic Data Analysis and Retrieval (SEDAR) was not in existence. With SEDAR, documents are filed electronically and made available to the public for free. At the time the prompt-offering and shelf procedures were introduced, the Internet was not as readily available or as widely used as it is now. It was not as easy to access publicly filed continuous disclosure documents as it is today. The prompt- and shelf-offering systems thus relied on the continuous disclosure documents being accessed by investors such as institutional investors whose significant investments allowed them to recoup the cost of accessing the documents and analyzing the information contained in them. Gathering and analysis of documents by institutional investors could protect other investors by institutional investor trading that would cause market prices to reflect the information contained in the continuous disclosure documents. Since the prompt- and shelf-offering systems arguably relied on institutional investor following, the eligibility requirements included requirements such as the market value of equity securities available for trading or approved ratings as indicators of likely or actual institutional investor-following.

The increased availability and use of the Internet, together with the development of SEDAR, means that investors can access disclosure documents much more readily than they could in the past. Prospectuses can now be delivered electronically. These developments make it increasingly unnecessary to require issuers to repeat the disclosures they have already made available on SEDAR in other disclosure documents. It might be argued that repeating the disclosure in a prospectus is necessary because information in continuous documents can be scattered over many documents. But with the extension of annual information form disclosure to all reporting issuers, and not just to reporting issuers that intend to use the prompt-offering and shelf-offering systems, this problem has been largely rectified.[181] The time has thus arguably come for issuers to be able to make a public offering that relies on the updated disclosure that it has been required to provide through continuous disclosure requirements, without having to unnecessarily repeat all the information in a new and lengthy prospectus document. Prospectus disclosure would be necessary for an issuer's first public offering. Subsequent offerings of different securities would require new disclosure that laid out the terms of the new securities and the details of the offering. Subsequent offerings of previously issued securities would only need to disclose such matters as the nature of the distribution and the use of the proceeds. Disclosure in these subsequent offerings could either incorporate by reference previous continuous disclosure, thereby subjecting all disclosure relating to the offering to statutory civil liability provisions relating to a prospectus (or misrepresentations on a public offering). In the alternative, statutory civil liability could be extended to continuous disclosure documents as well (as in Ontario and as was enacted by not proclaimed in British Columbia). This was essentially the approach taken in the B.C. Securities Act that was enacted in 2004, but not ultimately proclaimed.[182]

[181] See National Instrument 51-102, paragraph 6.1.
[182] The B.C. 2004 *Securities Act* would have allowed an issuer that had made a previous distribution of securities to make a new distribution of securities relying on its existing continuous disclosure without producing a whole new prospectus. The effect would be that for an issuer that had made a previous distribution of securities, there would be no separate extensive "primary market disclosure". There would only be its continuous disclosure (or secondary market disclosure) supplemented by disclosure concerning the nature of the particular securities being offered, the method of distribution and the use of the proceeds.

This sort of reform would not involve a fundamentally different approach to securities regulation than that in other jurisdictions. There would still be mandatory disclosure and the information disclosed could be just as detailed. Although electronic disclosure is available in several other jurisdictions, they have yet to take advantage of it in the way proposed. We are in a position to be ahead of many other jurisdictions in making such a reform, and it could reduce the transactions costs for issuers in making public offerings after their first initial public offering. It may also reduce administrative costs by substantially reducing the amount of disclosure that needs to be reviewed by securities administrators on many public offerings of securities.

Recommendation #2: **The integration of disclosure in short-form and shelf prospectuses should be extended to all issuers.**

Review of Disclosure Requirements and Disclosure Methods

A "misrepresentation" in Canadian securities legislation is defined to include "an omission to state a material fact that is required to be stated."[183] The prospectus forms contain a list of specific items.[184] The required disclosure goes beyond the specific items since it must provide "full, true and plain disclosure of all material facts" relating to the securities to be distributed.[185] Disclosure relating to specific facts is to be guided by an assessment of materiality.[186] One need not provide responses to inapplicable items.[187] Overall, the disclosure is guided by the concept of materiality which ties disclosure to whether the information "significantly affects, or could reasonably be expected to significantly affect, the market price or value of [the securities]".[188] Similar concepts apply to continuous disclosure forms. The specific items may serve as a sort of checklist of matters that should be considered, but I suspect that where the form refers to a specific item, there is a tendency for issuers, underwriters and their lawyers to err on the side of caution and address the specific item even where there is some doubt as to its materiality.[189] There may also be a tendency when creating such a list to err on the side of inclusion on the notion that *some* investors *may* consider the information useful, so why not make it available? But this does risk creating the concern that has been noted for many years that prospectuses are just too long and complicated for less-sophisticated investors and are perhaps becoming too long and complicated even for more-

[183] See *e.g.* Ontario *Securities Act*, *supra* note 83, s. 1.
[184] See, e.g., BC Form 41-601F.
[185] See, e.g., B.C. *Securities Act*, *supra* note 83, s. 63(1).
[186] See, e.g., BC Form 41-601F, Instruction (3).
[187] See, e.g., BC Form 41-601F, Instruction (6).
[188] B.C. *Securities Act*, *supra* note 83, s. 1(1) "material fact".
[189] See *supra* Part 5, iv, e).

sophisticated investors. We should therefore have another look at the required forms of disclosure with a view to reducing the extensiveness of disclosure requirements and thereby reduce compliance costs. In doing so we might consider factors such as:

- whether the cost to the issuer to produce the disclosure is likely to be relatively high or low;
- the likely significance of that sort of information to investors; and
- the extent to which disclosure for the particular item is likely to increase the overall amount of information.

We may also be able to find ways of further standardizing the presentation of information, and to present information in a way that allows investors to more easily retrieve relevant information and compare it to information disclosed by other issuers. The disclosure of executive compensation may be an example of this. Although the disclosure is extensive there are required tables that make key information easier to find and to compare with other issuers. There may be other areas in which this sort of standardization and simplification of presentation can be achieved. Making relevant information easier to identify and making it more readily comparable between issuers can reduce information costs for investors and thereby improve the competitiveness of the capital market.

We may be able to take better advantage of SEDAR as a way of making information accessible. One simple matter I have noticed is that other material documents filed with a prospectus are simply listed as "other documents" or some similar general appellation. If there are many such documents, one has to search through each one to find the desired document. Is there a way to better identify the document? Perhaps a more descriptive name could be given to each of these "other documents". These documents often have title pages. Could we at least show the title in the list of other documents? Perhaps there could be a single "other documents" link for a particular prospectus and when one makes the link, one is taken to a list of other documents that contain more detailed descriptions. Could we also improve the search engines so that we could do a keyword search through a range of documents for a particular issuer rather than, for example, having to guess at the document, load it up in pdf format, then search manually inside that pdf document only to find that it is not in that particular document? My tech skills are admittedly limited, but on the occasions I have made use of SEDAR I have wondered whether it holds much more potential for allowing persons using it to find the information they are seeking among the vast amount of information it makes available. It might thereby reduce information costs for investors and, in part, address the information overload concern by assisting users in more quickly finding the information they want.

<u>Recommendation #3</u>: Prospectus and continuous disclosure requirements should be reviewed with an eye to reducing specific requirements, simplifying presentation, improving comparability of disclosure and improving accessibility of information that has been disclosed.

<u>Recommendation #4</u>: Facilitate the search of "other documents" on SEDAR by identifying the documents more clearly.

b) Insider Trading

Task Force Report Recommendations

The recent Task Force Report on Insider Trading made numerous recommendations with respect to insider trading. Many of its recommendations are worth pursuing. The recommendations were generally directed to clarifying the prohibition provisions and to improving detection and enforcement. To the extent that detection and enforcement can be improved without significant increases in cost, and to the extent that it better deters insider trading, then it could improve confidence in the market, reducing the discounting of securities prices non-insider investors may be inclined to make to adjust for the incremental risk of uninformed trading caused by insider trades. A few of the Task Force Report recommendations are set out below.

Clarification of General Disclosure

We might give insiders more guidance concerning what constitutes "general disclosure" of information by identifying the kind of media that would be considered to satisfy "general disclosure". We might also set out a minimum period after disclosure in specified media that would be sufficient to allow non-insiders time to access the information and assess it. In other words, insiders could be confident that their trades would not be subject to sanction where they knew that the proper media for disclosure was used and they have waited for the specified minimum period of time for the information to be considered "generally disclosed" by way of that media.

<u>Recommendation #5a</u>: Identify the types of media that will be considered acceptable for the purposes of providing "general disclosure" of information.

<u>Recommendation #5b</u>: Set a period of time after disclosure through the media described in recommendation 5a after which insiders can trade without being subject to insider trading sanctions or civil liability.

Clarification of Exemption for Mutual Knowledge of Material Information

The Report was also concerned that an exemption from insider trading restrictions might apply where an insider has knowledge of undisclosed information that indicates the securities are worth more than the prevailing market price and directs, or causes, the issuer to issue securities to the insider. Such a transaction might be exempt because there is an exemption to the insider trading prohibition where the person who traded reasonably believed the other party to the transaction had knowledge of the inside information. The issuer might arguably be said to have knowledge of the information if the insider could be said to be part of the "directing mind" of the issuer. Such transactions could lead to wealth transfers from non-insider investors to insider investors and lead to the discounting of securities prices by non-insider investors. Thus the Report recommended that it be made clear that the exemption should not apply in such a situation.[190]

<u>Recommendation #6</u>: Add a provision making it clear that where an insider has knowledge of undisclosed information that indicates the securities are worth more than the prevailing market price and directs, or causes, the issuer to issue securities to the insider, such a transaction is not exempt on the basis that the insider reasonably believed the issuer had knowledge of the inside information.

Best Practices

The Task Force Report made recommendations for the adoption of "best practices" for issuers and their directors and senior officers, and for lawyers, accountants, banks and dealers. For issuers, these would include guidance on how to maintain the confidentiality of corporate information and the prevention of insider trading. The Task Force Report recommended that the suitability of persons to act as directors and officers be subject to review if they fail to fulfill their responsibilities in this regard.[191] The mechanism to give lawyers an incentive to adopt standards that might be developed by the Canadian Bar Associations and provincial law societies would be to require issuers to only retain lawyers who have adopted best

[190] *Task Force Report*, *supra* note 138, at 22.
[191] *Ibid.* at 11.

practices on information containment, and that failure of issuers to do so could result in a review of the suitability of directors and senior officers of the issuer.[192] The Task Force Report also recommended that the Canadian Securities Administrators and the Canadian Institute of Chartered Accountants work together to develop best practices for information containment for accountants. It also recommended that issuers retain only accountants that have adopted the best practices, and that the suitability of directors and senior officers of issuers be subject to review if they fail to do so.[193]

<u>Recommendation #7</u>: Follow through with the recommendations of the Task Force Report on Insider Trading with respect to the adoption of best practices for issuers and their directors and senior officers, and for lawyers, accountants, banks and dealers.

Improved Detection

The Report made several recommendations to improve the detection of insider trading. For instance, where suspicious transactions are identified and issuers are contacted, they often either don't respond or respond that there is no material information and the issuer shortly thereafter makes a public announcement of a significant event.[194] The Report suggests that the securities regulators and enforcement arms of the stock exchanges develop an enforceable obligation on issuers to provide full disclosure of not just material but also "potentially material" events on request.[195] The Task Force Report also recommended development of an electronic database that integrates information on trades with data such as the names, addresses, and affiliated entitiesm to facilitate investigations by allowing electronic identifications of patterns or potential linkages.[196]

The Task Force Report recommended consideration of requiring the prohibition of trading in an account or requiring that assets accumulated in an account be retained until the beneficial ownership in the account is verified.[197] It recommended that the Investment Dealers Association consider, in the context of

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[192] *Ibid.* at 12-13.
[193] *Ibid.* at 13-14.
[194] *Ibid.* at 24.
[195] *Ibid.* at 23-25. Issuers would not have to be constantly checking whether developments concerning the issuer were "potential material events". It would be the enforcement arm of the stock exchange, on observing some aberrant behaviour in the issuer's securities prices or trading volumes, that would contact the issuer for an explanation. The issuer would then have an obligation to disclose, confidentially, to the enforcement arm of the stock exchange potentially material events that might explain the unusual securities price of trading volume behaviour.
[196] *Ibid.* at 25
[197] *Ibid.* at 32.

offshore financial institution accounts, the costs and benefits of requiring that members obtain consents from the institution to identify, on request, to the appropriate Canadian regulator, the individual responsible for the trade.[198] The Task Force Report further recommended that where persons are allowed to trade directly (i.e., not through a dealer) that access "be prohibited for persons who do not reside in a jurisdiction with a satisfactory regulatory regime unless the person agrees in writing to make available to the market regulator on request all information, including bank account information relating to trading conducted through that account."[199] Jurisdictions not having a "satisfactory regulatory regime" could be identified through a blacklist developed by the Financial Action Task Force that is developing policies to combat money laundering. The Task Force Report recommended the addition to this list countries that either are not members of the International Organization of Securities Commissions ("IOSCO") or that have not signed the Memorandum of Understanding concerning Consultation, Cooperation and the Exchange of Information developed by IOSCO (the "MOU"). This MOU calls for the sharing of trading information between regulators and information related to trading, such as banking information and information on beneficial ownership. IOSCO member regulators, prior to signing the MOU, must establish that they are legally capable of meeting the information sharing requirements of the MOU.[200] The Task Force Report also recommended that the costs and benefits of requiring securities dealers to put markers on trades through offshore accounts be evaluated.[201]

The Task Force Report also recommended that "Integrated Market Enforcement Teams", set up by the federal government to investigate capital market frauds, have the lead in investigations of insider trading with securities commissions and self-regulatory organizations as a subgroup of the Integrated Market Enforcement Team.[202]

<u>Recommendation #8</u>: Follow through with the recommendations of the Task Force on Insider Trading with respect to the detection of insider trading.

Administrative Sanctions as the Primary Enforcement Technique

Given the enforcement problems that plague penal sanctions, securities administrators should continue to rely primarily on administrative sanctions, together with publication of their administrative enforcement

[198] *Ibid.* at 32.
[199] *Ibid.* at 33.
[200] *Ibid.* at 29-31.
[201] *Ibid.* at 29.
[202] *Ibid.* at 44-45.

activities against insider trading. The lower burden of proof for administrative sanctions increases the probability of sanctioning of insider trading, and is thus likely to have a greater deterrent effect than rarely, if ever, enforced penal sanctions. A more effective deterrence of insider trading through increased detection and enforcement should give investors greater confidence that they will not incur incremental uninformed trading losses potentially caused by insider trading.

Recommendation #9: Continue to rely on administrative sanctions as the primary enforcement technique for the prohibition of insider trading and informing.

A Phantom Stock Alternative

One way in which the potential agency cost-reducing benefits of insider trading might be obtained without removing the prohibition on insider trading would be to allow issuer management to engage in phantom stock trading. A phantom stock option would not involve trading in the securities of the issuer. Instead the executive would be given a notional stock option. When the executive exercised the option, no securities would be issued to the executive by the issuer. Instead the issuer would make a bookkeeping entry indicating that the executive had the specified number of the particular security related to the options the executive had exercised. When the executive sold the notional securities the executive would be paid the difference between the market price for security and the exercise price on the option. No securities would actually be sold. The issuer would simply make a bookkeeping entry reducing the number of the particular security held by the executive.

With such a phantom stock option, assuming the prohibition of insider trading was effective, there would be no incremental uninformed investor loss due to insider trading because insiders would not be trading in market and ending up with more of the securities prior to the disclosure of favourable information or less of the securities prior to disclosure of unfavourable information. There would be no benefit to leaking the information to others, such as friends and relatives, because only specified managers of the issuer could engage in the phantom stock trading. There would be no perverse performance incentive associated with short sales of the issuer's securities since the executive could not short-sell under the phantom stock option regime. The loss to investors would be the cost to the issuer of compensating managers in part according to their phantom stock gains. This form of compensation should be reported together with all other forms of executive compensation, allowing the market to assess the efficacy of the any phantom stock program adopted by a particular issuer. Legislation would be needed to expressly permit such phantom stock programs, but restricting such programs to management of the issuer. In short, it is simply a way of allowing issuers to get the potential advantages that Manne claimed exist for insider trading as a superior compensation technique with the alleged harms of insider trading. Issuers might not adopt such a scheme, but they would have the opportunity to. In addition, like other compensation schemes, it would be subject to market and governance mechanisms (such as compensation committee approval).

Recommendation #10: Consider enacting a provision that clarifies that a phantom stock option regime is neither a violation of the insider trading prohibition nor contrary to the public interest if it complies with specified restrictions.

Information Connection Approach

It may be worth further investigating an "information-connection" approach to insider trading as suggested by the Task Force Report on insider trading.

Recommendation #11: Examine the possibility of replacing the current combined "person-connection" and "information-connection" approach to insider trading with just an "information-connection" approach as suggested by the Task Force on Insider Trading.

c) Takeover Bid Regulation

A Market-Based Takeover Regime

It has become more common over the past several years for issuers to adopt poison pill plans. These plans usually expand upon takeover bid regulation requirements. Poison pill plans could, in theory, replace takeover bid regulation entirely, leaving the regulation of bids to issuers through poison pills. Securities regulation might need to control against the adoption of plans that permit target management from completely blocking takeovers, but the mechanics of bids might be left to be determined by issuers under poison pill plans. It should prevent the adoption of poison pill plans without the approval of shareholders and perhaps also prevent approvals from being bundled with other approvals such as significant dividends or share repurchases. If the market can properly assess these plans, then more restrictive plans that are likely to significantly deter bids that might replace poorly performing managements should lead to much lower prices for issuers with such plans. Other issuers that have plans that provide a proper balance between protecting the interests of investors and retaining the potential for replacement of poorly performing managers should attract much higher prices in the market. In-house schemes might avoid the compliance costs that may be incurred in reorganizations that trigger takeover bid regulation requirements in situations where the concerns for which takeover bid regulation requirements were created do not really arise.

<u>Recommendation #12a</u>: Repeal existing takeover bid regulations and replace them with a specific requirement that poison pill plans be subject to shareholder approval. Retain the principle in National Policy 62-202 that takeover defences should not deny shareholders of the ability to make fully informed decisions.

An Opt-Out Takeover Bid Regime

An alternative to a strictly market-based takeover bid regime would be to allow an issuer to opt out of the securities regulatory takeover bid regime. To some extent this already occurs where issuers adopt poison pills that expand on the existing securities law requirements. But issuers can not choose to have lower requirements than those contained in securities legislation. In a full opt-out regime issuers would be able to either have no takeover bid requirements or to have something less than those provided for in the securities legislation. That would allow more room for issuer management to signal their intent to act in the interests of investors. They could expose themselves to a greater potential for being removed from office after a takeover, giving investors greater confidence that they would not find themselves holding investments in an issuer that is being poorly managed with little likelihood of being replaced.

<u>Recommendation #12b</u>: In the alternative, instead of repealing the existing takeover bid laws, retain them but allow issuers to opt out of the rules, thereby freeing issuers to adopt rules with less than the minimum requirements provided for under the existing takeover bid rules.

Restoring First-Bidder Incentives

Takeover bids have decreased significantly in recent years. This may have been in large measure due to changes to takeover bid regulation, particularly the increase in the minimum bid period. This reduces the takeover bid as a device to control for poor corporate governance. It puts additional pressure on other governance devices that may not be up to the task, as recent concerns over corporate governance suggest. The reduced potential for a takeover is probably much more significant than the reduction in the number of takeovers. The potential for a takeover may have a significant effect on the incentive of managers to perform effectively in the interests of investors. If a market-based or opt-out approach seems too extreme then we should at least consider finding ways of restoring incentives to do takeovers. This might be done by reducing the bid period or by increasing the takeover bid trigger to more than 20%. Bidders, particularly first bidders, need to be able to tender under competing bids and realize gains on the shares acquired prior to making a takeover bid in order to cover the costs incurred in making a bid.

<u>Recommendation #12c</u>: If alternatives 12a and 12 b are not adopted, then consider increasing the threshold for takeover bids to something more than 20%, in order to increase returns to first-bidders and thereby improve the agency cost controlling effects of takeover bids.

d) General Reforms

Third-Party Enforcement Techniques

While there may be limits on variations in substantive law requirements that one can effect without risking migration of issuers and investors, one area in which a more competitive capital market may be obtained under existing substantive provisions is enforcement. Here the objective would be to secure increased compliance at lower cost. An enforcement technique that is provided for in some jurisdictions is an order directing a firm to submit to a review of their practices and procedures and to institute such changes as the securities commission may order in light of the review.[203] The cost of the review could be reduced by having the review done by a third party and having the firm subject to the review order pay for the review.[204] Thus, where significant or repeated violations of securities regulatory requirements have occurred, the firm (e.g. an issuer or securities industry participant) could be required to an independent third-party consultant at its own expense. The independent third-party consultant would be directed to investigate the firm and recommend appropriate remedial steps. The administrative powers of securities commissions could be used to both require the retention of a third-party consultant and to enforce adoption of its recommendations. The potential advantage of such an approach is its prospective focus, its potential to focus on correcting a firm culture that may be prone to securities law violations, and that

[203] See *e.g.* Ontario *Securities Act*, supra note 83, s. 127, para. 4. See also *e.g.* Alberta *Securities Act*, R.S.A. 2000, c. S-4, s. 197(4)(g), as amended by S.A. 2005, c. 18, s. 24.

[204] Under the Alberta provision, *supra* note 203, the review is to be done by the Commission. There are provisions for the payment of the costs of an investigation (see e.g. Ontario *Securities Act*, *supra* note 83, s. 127.1; and Alberta *Securities Act*, *supra* note 203, s. 202) but these provisions refer to the costs of an "investigation" not a review ordered by the Commission. Thus it is not clear in the case of the Alberta provision that a third-party review could be ordered and it is not clear under either the Alberta or Ontario provisions that the firm subject to the review can be ordered to pay the costs.

its cost is not borne by the securities commission.[205]

<u>Recommendation #13</u>: Consider increased reliance on third-party enforcement techniques.

Review Legislation and Rules for Simplification

The sheer volume of securities regulation, together with its perceived complexity, probably raises both the cost of determining what is required to comply and the fees paid for legal advice concerning compliance. Undue volume and complexity is prone to be detrimental to compliance. There will be a temptation to try to avoid high compliance costs. There will be an increased risk that even the best-intentioned issuers and securities industry participants will miss a requirement. Reduced compliance may negatively affect investor confidence in the market. Attracting foreign issuers and investors may, in part, be a function of the cost of determining what is required to comply. If compliance costs can be reduced without compromising the benefits of the regulatory regime, then it will help make the capital market more competitive.

So what can be done to reduce compliance costs associated with the volume and complexity of securities regulation? There seems to be a move toward making the language in securities rules simpler, and an improvement in explaining the rules in companion policies. But the legislation that sets out the regulatory framework is now nearly thirty years old. Many modifications have been made over the years. It is perhaps time for a review of the legislation with a view to removing provisions that are perhaps no longer necessary, to make the provisions more clearly fit with the move toward rule-based modifications of the regulatory scheme and, where possible, to simplify the language of the provisions.

<u>Recommendation #14</u>: Review of the legislation with a view to removing provisions that are perhaps no longer necessary, to make the provisions more clearly fit with the move toward rule-based modifications of the regulatory scheme and, where possible, to simplify the language of the provisions.

[205] On third-party enforcement techniques in the context of securities regulation see Cristie L. Ford, "Toward a New Model for Securities Law Enforcement" (2005) 57 Administrative Law Rev. 757.

Continued Work on Harmonization

The incremental transactions costs imposed by Canada's multi-jurisdictional regulatory structure has been extensively studied and commented upon. Several suggestions have been made as to how to address this problem. The problem has been discussed for several decades, and the arguably limited response to the problem over those many years, despite numerous suggestions for reform, indicates that the reform ideas are generally not easily achieved given the political dimensions of the problem. Even so, efforts to address the incremental costs that our multi-jurisdictional regulatory structure may impose should continue. In the short term, this may involve continued efforts at harmonization. In the longer term, perhaps some form of the "passport" approach or joint regulatory body can be taken.

Recommendation #15: Efforts to address the incremental costs that our multi-jurisdictional regulatory structure may impose should continue. In the short term, this may involve continued efforts at harmonization. In the longer term, perhaps some form of the "passport" approach or joint regulatory body approach can be taken.

11. <u>Some More Radical Suggestions and Concluding Remarks</u>

I suggested at the beginning of Part 10 that more radical (or fundamental) reforms to securities regulation may be difficult to implement in the context of international capital markets, particularly for a relatively capital market like that in Canada. What types of reforms might be considered more radical reforms? I suggested in Part 10 that the issuer and investor regulation discussed in Part 5, iv, would be more radical (or fundamental). I have also set out some recommendations that might be considered by some to be radical. For instance, I have suggested that takeover bid regulation might be repealed, and a phantom stock option regime to replicate the alleged potential benefits of insider trading as a compensation technique without actually allowing insider trading.

What else might be more radical? The paper reviews traditional arguments concerning the role of securities regulation in the areas of mandatory disclosure, insider trading, market manipulation, takeover bid regulation and securities industry regulation. It also reviews critiques of those traditional arguments, particularly in the areas of mandatory disclosure, insider trading and takeover bid regulation. The critiques challenge the traditional arguments in those areas, and thus a more radical reform of securities regulation might be to repeal mandatory disclosure laws, insider trading prohibitions and takeover bid rules. I suspect many persons would find one or more of those suggestions to be quite radical. I would hesitate to advance these reforms not only because I suspect they might well lead to a flight of capital from Canadian capital markets because of the uncertainty they might create, but also because there have been reasonably plausible arguments in favour of regulation in each of these areas (some of which were reviewed in Parts 5, 6 and 8).

The recommendations in Part 10 might more appropriately be styled "suggestions". As an academic I have one strong belief: to avoid holding *other* beliefs too strongly. Strong beliefs have a tendency to close the mind to new ideas. So, quite frankly, I haven't decided whether or not we should have mandatory disclosure, the prohibition of insider trading or takeover bid regulation.[206]

With that in mind, here are a few further thoughts on the areas of mandatory disclosure, insider trading and takeover bid regulation. It is now a little over twenty years since I first began studying securities regulation. In that time there has been an expansion in the forms of required disclosure with, for instance, the addition of annual information forms, replete with management discussion and analysis, and now the

[206] I have, however, expressed the position here and elsewhere that the regulation of takeover bids could be left to the market. That's my predilection but hopefully it's not too strong a predilection.

addition of business acquisition reports. It has been my impression that the amount of disclosure in particular documents has increased considerably. Long-form prospectuses are much longer than I remember them being, and even short-form prospectuses seem to have grown in size. Annual information forms can also be quite long. Perhaps this expansion in information makes sense in light of technological improvements that have allowed for more ready access to the information and electronic search techniques that may allow analysts to hunt down the most relevant information buried in very long documents. But I can't help but think that, even with these technological improvements, the amount of information has gotten to the point that costs to the user may well exceed the benefits, and that is without taking into account the cost to the issuer in providing the vast amounts of information they now have to provide. This cost-benefit question is, of course, an empirical question. Perhaps this empirical question can be explored.

Further research should also be conducted along the lines suggested by Paredes.[207] What information is important to investment analysts? Can types of information be ranked in terms of relative importance? How do they go about finding the important information? Can that important information can be provided in a way that makes it more accessible and more readily comparable between issuers? This kind of research may allow us to reduce the overall amount of disclosure and improve its usefulness.

I also wonder whether forms for disclosure really need to be mandated through regulation. What issuers may need is a way to credibly signal the quality of the disclosures they make. That would have been difficult in Canada in the 1930s. There was no common law action for negligent misrepresentation and contractual warranties may have had limited usefulness, given the reticence towards allowing third-party beneficiaries to enforce them.[208] Since then we have the concept of a collateral warranty and, more importantly, an action for negligent misrepresentation. The negligent misrepresentation action, however, requires proof of duty, reliance, negligence and causation. The reliance and causation elements limit the usefulness of the negligent misrepresentation claim in securities actions. The statutory civil liability provision for misrepresentations in a prospectus and the recent Ontario statutory civil liability for misrepresentations in continuous disclosure documents respond to these limitations. Perhaps this is all

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[207] See *supra* Part 5, iv, e).

[208] The issuer might provide some form of contractual warranty as to the accuracy of its disclosure. It might then ensure that all sales in the distribution would be through agents for the issuer so that there was a direct contractual relationship between the issuer and the purchasers. An alternative might have been to have the underwriter, or underwriters, provide the contractual warranty and have the contractual relationship between the purchasers and the underwriter (in, for instance, a bought deal). The price, however, that the purchasers in the public distribution would be willing to pay would likely be tempered by the price for which they might be able to subsequently sell the securities to other investors who would not be able to enforce a contractual warranty as to the accuracy of the issuer's disclosure.

that is really needed – the prospect of an action created by statute that allows issuers, underwriters and others involved in the preparation of disclosure documents to credibly signal the quality of their disclosure.[209] Perhaps also it may only need to be an opt-in provision with the requirement that purchasers be given a pre-purchase document that clearly indicates whether the issuer and others have opted to have the provision applicable to their disclosures. The rest of the details of disclosure might then be left to the market where, through stock exchange requirements or otherwise, standard forms for disclosure could develop.

A statutory civil liability sanction would provide a stronger private means of redress for misleading disclosure. Would that be enough to provide a credible signal? Perhaps it also needs to be supported by administrative and penal sanctions. If needed, these might also be statutorily provided on an opt-in basis.

I'm not entirely convinced by the credible commitment theory argument that adoption of a statutory disclosure regime is necessary for a credible commitment. Couldn't disclosure requirement commitments be put in the constating documents of the issuer together with supermajority, or even majority of the minority, voting requirements for amendment?

On the insider trading front, it seems to me that among all the arguments that have been made, particularly in an enormous literature over the past forty-plus years, there is no clearly definitive argument (or set of arguments) either in favour of or against the prohibition of insider trading. The arguments raise empirical questions and the only real answer ultimately lies in empirical analysis, of which there has been virtually none until relatively recently (primarily in the last 15 to 20 years). That is why I reviewed some of the evidence in this paper.[210] Some of the evidence supports arguments against the prohibition of insider trading. Some of it supports arguments in favour of the prohibition of insider trading. My view is that, on balance, some of the very most recent evidence leans more heavily in favour of the prohibition of insider trading. So, at least for now, I'm inclined to support recommendations on insider trading made by the Task Force on Insider Trading a few years ago.

On the takeover bid regulation front I am inclined, as noted, to leave that to the market. It seems to me that the optimal regime is likely to vary a great deal from one issuer to another and so they ought to be left

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[209] It may need to be by statute, since otherwise issuers and underwriters will be left with the confines of existing common law contractual actions or tort action for deceit or negligent misrepresentation. These, for the reasons suggested in the text, may not permit issuers, underwriters and others a basis for a strong enough signal of their commitment to the good quality disclosure.

[210] I have an unpublished paper that surveys this evidence in much more detail.

with more flexibility to craft their own regimes. The legislation does leave some scope for this since it sets only minimums. More restrictive regimes can be crafted through poison pills. But the legislation does not let issuers get to a regime that requires less than the minimum. In recent years the legislation set stronger minimums increasing, for instance, the minimum bid period. I wonder whether this has put a sufficiently significant constraint on this potentially valuable governance/agency cost-control mechanism that it may have been a contributing factor in the apparent increase in corporate governance scandals. Suppose you have range of agency cost-control mechanisms. No doubt it is difficult for market actors to identify the best technique to adopt, but, at least in theory, they should adopt techniques from the range of available techniques to the point that the ratio of marginal cost to marginal gain of each technique adopted is equated. Now you constrain a particular technique (the takeover bid) so that it is relatively more costly to adopt. The market must now shift to other techniques that, prior to the restrictions on the takeover bid technique were costly relative to the benefits they provided in terms of reduced agency costs. In short, we are left with more agency costs, or, in other words, weaker corporate governance. There needs to be a compelling argument in favour of restricting takeover bids as a corporate governance device and to me the many arguments in made in the debate over mandatory takeover bid rules are not sufficiently compelling, particularly in light of the available empirical evidence.[211]

[211] I have not spelled the arguments or surveyed the evidence in detail in this paper but see the evidence briefly summarized *supra* notes 160 to 178 and the literature cited therein.

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