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Research Study

The Characteristics of Canada's Capital Markets and the Illustrative Case of Canada's Legislative Regulatory Response to *Sarbanes-Oxley*

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Maintaining a Competitive Capital Market in Canada

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1. <u>Executive Summary</u>

Distinct Canadian Capital Market Characteristics

The distinctive characteristics of Canada's capital markets (or, more precisely, Canada's equity markets) are, in general terms, well known to market participants. The principal features of the Canadian capital markets include the following:

- Canadian issuers constitute a small fraction of total world market capitalization
    - The market capitalization of Canadian issuers represents about 3% of total world market capitalization
- The market capitalization of Canadian public companies is high relative to GDP, a measure indicative of relatively well-developed capital markets:
    - A Bank of Canada study in 2004 indicated that the market capitalization of exchange-listed issuers in Canada represented about 98% of Canadian GDP. Based on 2005 data, it appears that this percentage may be even higher—approximately 110% of GDP. [1] By comparison, the market capitalization of issuers on America's three principal exchanges represented about 130% of U.S. GDP, while market capitalization on the London Stock Exchange represented about 79% of U.K. GDP (Hendry & King, 2004) It has been noted that it many other countries (including large industrial countries such as Germany and France) stock markets are much smaller as a proportion of GDP (e.g., Tirole, 2006)
- Canada's public equity markets are characterized by a small number of large issuers and a far greater number of small issuers—including a significant number of micro-cap issuers:
    - Large Issuers: The market capitalization of the 200 largest listed issuers accounts for more than 88% of the total market capitalization of all TSX- and TSX Venture Exchange-listed companies.

[1] Canada's GDP in 2004 was approximately $1.293 trillion. Using a December 31, 2004 Canada/U.S. exchange rate of 1.2034, Canada's GDP would equal about U.S. $1.07 trillion. The market capitalization of Canadian-listed issuers is approximately U.S. $1.178 trillion, or about 109.6% of GDP.

- Small Issuers: There are more than 1000 listed companies in Canada (approximately 29% of the companies for which data is available) with market capitalization of less than $5 million, plus another 385 companies (about 11%) with market capitalization of between $5 million and $10 million. The market capitalization of the smallest 2000 listed issuers (about 57% of the total number of listed companies) accounts for less than 9% of the total market capitalization of all TSX- and TSX Venture Exchange-listed companies. This suggests that Canadian issuers are compelled (or incentivized) to go public at an earlier stage in their development than U.S. firms.

- The relative significance of larger and smaller public companies varies by region:

  - As Stephen Sibold has pointed out in a submission to the Taskforce, the distribution of large and small companies is not uniform across Canadian jurisdictions: a disproportionate number of Canada's largest issuers are headquartered in Ontario, and a disproportionate number of Canada's smallest issuers are headquartered in British Columbia and, to a lesser extent, Alberta. (Sibold, 2005).

- A significant number of Canada's largest issuers are also listed on major U.S. exchanges. (A number of Canadian issuers of varying sizes also trade in U.S. and other foreign markets)

  - 177 Canadian issuers are cross-listed on U.S. exchanges, and more than 250 other Canadian issuers trade over the counter in the United States. Many Canadian issuers are also listed on other foreign exchanges. For example, about 48 Canadian companies are listed on the London Stock Exchange.[2]

- A significant percentage of Canada's largest non-financial public companies have controlling shareholders, or major shareholders (shareholders with voting interests in excess of 20% or 10%)

  - Closely related to the fact that many of Canada's public corporations are legally or effectively controlled (indeed the means by which such control is often achieved), is the prevalence in Canada of dual-class shares and pyramidal holding structures. The effect of such techniques is to sever voting control from cash flow rights.

[2] A recent media report suggested that a significant number of Canadian companies have recently sought to list on the LSE's Alternative Investment Market (AIM), purportedly because AIM "doesn't impose the same governance and disclosure laws that have been enforced on public North American companies in reaction to an outbreak of corporate fraud." See "Stikemans Takes AIM at London IPO Market" *Globe and Mail* (29 March, 2006) at B10.

- A significant percentage of Canada's public companies operate in a handful of key sectors, specifically mining, oil and gas, and financial services
    - See Figures 12 and 13, below.

Link Between Market Characteristics and Regulation

It has been suggested that the distinct characteristics of Canada's capital markets may be suggestive of optimal regulatory approaches that differ in some respects from regulatory initiatives undertaken in other markets (such as the United States and the United Kingdom) with differing capital market characteristics (See, e.g., MacIntosh & Daniels, 1991; Daniels & Morck, 1996).

Specifically, it has been suggested that:

- The prevalence of small public companies in Canada means that an emphasis on complex, mandatory formal corporate governance rules may prove disproportionately burdensome for a significant number of Canadian public companies, and yield limited benefit to Canadian investors.

This observation highlights an apparent regulatory paradox. The very companies supposedly least able to afford enhanced regulatory burdens are also the companies that potentially pose the greatest investment risk for retail investors, since shares of smaller firms are typically subject to greater price volatility, expose investors to greater illiquidity risk, and are less likely to be under the watchful monitoring eye of sophisticated institutional investors. Smaller firms, as well, owing to more limited staff resources, may have less sophisticated control mechanisms in place. Thus, as the 2003 OSC analysis on the costs and benefits of recent regulatory initiatives put it, "erroneous financial reporting is especially prevalent among smaller firms."[3]

Recent debacles involving firms such as Enron and Worldcom have made it obvious that controls at even the largest corporations can be circumvented in egregious ways and, as a Task Force member has observed, the potential for large aggregate losses is, by definition, greater in the case of larger companies. Nevertheless, despite the recent high-profile debacles at several major corporations, it is still generally understood and widely-accepted that safe "blue-chip" stocks are those issued by the *largest,* not by the smallest issuers. Thus, in 1991 Daniels and MacIntosh criticized the fact that Canada's legal regime

[3] *Investor Confidence Initiatives: A Cost-Benefit Analysis* (2003), 26 OSCB 5010 at 5013.

tended to treat all public companies alike, when, in their view, "There would appear to be a greater role in the second market [i.e. for small public companies] for regulatory law that constrains the behaviour of corporate insiders, including both managers and controlling shareholders."

Yet a frequently-heard (and often accepted) plea is that such smaller companies cannot afford the "disproportionate" burdens of regulation, and so should be relieved of some of the governance rules to which larger corporations are made subject.

To be clear, it is certainly not suggested here that regulation of large public companies is not important. Clearly it is. Rather, the point is only that the *relative* importance to individual investors of securities regulation in the case of larger and smaller issuers may not necessarily correspond to the relative *intensity* of regulation actually observed.

- In widely-held corporations, the central agency concern - and, accordingly, the principal regulatory concern - relates to the relationship between a corporation's shareholders and the corporation's managers. In a system characterized by public companies with controlling shareholders, the central agency concern pertains, instead, to the relationship between majority and minority shareholders. (Coffee, 2005; Daniels and MacIntosh, 1981) The prevalence of controlling shareholders in Canadian public corporations thus means that "dealing with controlling shareholders is…the central issue in Canadian corporate governance." (Daniels & Morck, 1995).
  Canada's equity markets are neither a leading choice for cross-listing by foreign issuers (as, for example, the London Stock Exchange is); nor are they large enough to ensure that they will remain the primary markets for the largest Canadian companies (as, for example, the New York Stock Exchange is for most large U.S. issuers)

Notwithstanding material differences between Canadian capital markets and those of other countries, notably the United States and the United Kingdom, Canadian legislators and securities regulators perceive significant pressures to respond to major international (especially U.S.) corporate governance and capital market regulatory initiatives. Canadian regulators regularly voice concern about the national and international reputation of Canada's capital market regulation. In particular, they worry that the substance of Canadian rules or the enforcement of those rules may invite unfavourable comparisons with U.S. regulatory practices and consequently be derided as unduly lax. Considerable tension therefore exists between the need, on the one hand, to signal the credibility of Canadian securities markets - and by extension, the credibility of those Canadian issuers that seek access to foreign capital - and the recognition, on the other hand, that regulation designed in larger markets for larger companies with widely-dispersed shareholders may prove inappropriate, ineffective and unduly burdensome for a material number of Canadian public companies.

This tension became apparent during the regulatory process that culminated in a series of Canadian securities regulatory reforms introduced in response to the sweeping American corporate governance initiatives associated with the *Sarbanes-Oxley Act of 2002.* The Canadian regulatory response, after some false starts, was embodied in a number of national and multilateral instruments and policies. This regulatory bundle was said to reflect thoughtful consideration of the distinct characteristics of Canada's capital markets and to embody the goals of "proportional regulation" or "scaled regulation" - phrases that appear to be preferred by regulators over the more accurate, but less politically sensitive moniker: "two-tier regulation." The Canadian response to *Sarbanes-Oxley* is still, in some respects, a work in progress; but an examination of some of the features of those Canadian rules intended to parallel (in whole or in part) American corporate governance reforms helps contextualize and illuminate the ongoing challenge faced by Canadian securities regulators seeking to bolster investor confidence without unduly burdening Canadian firms.

In these recent initiatives, Canadian securities regulators have focused on governance measures aimed principally at enhancing the reliability of disclosure and lessening the probability of accounting scandals. The proffered reforms deal with several issues that would conventionally be regarded as matters of internal corporate law rather than securities regulation. It is not clear how extensively Canadian securities regulators considered whether and to what extent it would be relevant, in the process of crafting securities reforms, to take account of differences between various Canadian and U.S. corporate law statutes (especially the CBCA, on the one hand, and Delaware's General Corporation Law, on the other). Of course, large Canadian corporations with widely-dispersed shareholders are no less immune to accounting irregularities than such entities in the United States or elsewhere. The recent series of financial restatements at Nortel provide a salient example.[4] Nevertheless, the fact that a relatively small number of Canada's largest corporations are widely-held suggests that the emphasis of Canadian securities regulation may properly differ from the emphasis of U.S. securities regulation. Specifically, the prevalence of public corporations with controlling or dominant shareholders indicates that the relative emphasis of Canadian regulation should be on ensuring investors and prospective investors that minority shareholders of Canadian public corporations are credibly protected against abuse by controlling

[4] In Nortel's case, it is interesting to note that the accounting problems appeared to begin after Nortel became a widely-owned public company. (Prior to May 2000, it will be recalled, Nortel was a more "typical" Canadian public company with a significant *de facto* control block holder--BCE Inc.)

shareholders in the context of (a) related-party transactions; (b) going private transactions; and (b) unlawful trading on the basis of undisclosed material information (i.e., insider trading).

A Task Force member has, quite properly, queried whether the theoretically greater risk of abuse by controlling shareholders of larger Canadian public companies is, in fact, evidenced by concrete examples of such abuse. It is admittedly difficult to demonstrate definitively and empirically that one sort of agency problem (controlling vs. minority shareholders) is or is not more prevalent than another (management vs. shareholders). At the risk of overemphasizing the significance of selected recent salient events,[5] however, it is suggested that the details of Ford's transfer-pricing structures revealed by the *Ford v. Omers*[6] case provide a high-profile recent example of how a Canadian public corporation with a controlling shareholder can be managed for the purpose of benefiting the controlling shareholder at the expense of the minority shareholders of the controlled company. The fact that such practices can evidently continue largely undetected for many years is also sobering. And although it might be argued that the OSC was tilting at windmills when it first sought to regulate related-party transactions, Daniels and MacIntosh (1991) have provided a detailed account of the controversial 1989 sale of Westfield's mining assets that preceded significant revisions to OSC Policy 9.1,[7] the predecessor to Rule 61-501. It is certainly possible that examples such as these are exceedingly rare. However, it is suggested that regulators ignore at their peril the fact that the prevalence of controlling shareholders in many Canada's public companies does create conditions under which the potential for majority-minority abuse is exacerbated, and that there is at least some evidence to suggest that such risk is not only theoretical. Further, in a well-meaning effort to match much of the rigour of the U.S. rules-based system, Canadian regulators may lose the opportunity to facilitate a more flexible regulatory regime such as that of the United Kingdom where the London Stock Exchange is currently enjoying considerable success in attracting foreign issuers. As a heavily-regulated small market, there is some risk that Canada will not be attractive as an alternative either to the similarly-regulated but much deeper U.S. market, or to the more flexibly-regulated U.K. market.

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[5] There is a well-recognized human cognitive bias referred to as the "availability heuristic"—the tendency "to estimate the frequency of an event, or class of events, by the ease with which we can summon relevant examples from memory." See Robert H. Frank, "Departures from Rational Choice: With and Without Regret" in Francesco Parisi and Vernon L. Smith, ed., *The Law and Economics of Irrational Behavior* (Stanford: Stanford Economics and Finance, 2005) 13 at 15.

[6] *Ford Motor Company of Canada, Ltd. v. Ontario Municipal Employees Retirement Board* (2004), 41 B.L.R. (3d) 74 (Ont. S.C.J.); vard. (2006), 12 B.L.R. (4th) 189 (Ont. C.A.); application for leave to appeal to SCC filed March 6, 2006.

[7] (1991) 14 OSCB 3345. Prior to the 1991 revisions, OSC Policy 9.1 dealt with going private transactions, issuer bids and insider bids, but not other related party transactions.

2. Summary of Recommendations

There has been no shortage of proposals for securities regulatory reform in Canada in the past several years. Many of those proposals have advocated the creation in Canada of a single, national securities regulator.[8] An alternative "passport" model, embodied in a 2004 "Provincial/Territorial Memorandum of Understanding Regarding Securities Regulation" has also been advanced by ministers responsible for securities regulation in every Canadian province except Ontario.[9]

More ambitious reform agendas might be imagined - proposals, for example, that might seek to deal comprehensively with all financial market regulation, and may be grounded in a functional rather than an institutional model of capital market regulation.[10] Several countries, including the United Kingdom, Germany, Japan and the Republic of Ireland have opted for a regulatory model involving a single financial services regulator. (See Ferran, 2003). Given Canada's halting progress toward the less ambitious goal of consolidating securities regulation, it is unrealistic to suggest at this time that Canada seriously consider establishing its own equivalent of the U.K. Financial Services Authority.

Certainly the national scope of the Canadian securities industry makes the case for a cost-effective, single regulator compelling. But that familiar debate will not be joined here. Further, the central features of Canada's capital markets - a small number of large issuers, mainly based in central Canada, and a very large number of small issuers, dominated by firms in a discrete number of business sectors, and disproportionately represented by firms in Western Canada - have led to suggestions in the past that Canadian securities regulation might usefully be administered in a way that takes advantage of local

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[8] See, e.g., *Five Year Review Committee Final Report - Reviewing the Securities Act* (Ontario) (Queen's Printer for Ontario, 2003); Wise Persons' Committee to Review the Structure of Securities Regulation in Canada, *It's Time* (December 2003); Crawford Panel on A Single Canadian Securities Regulator, *A Blueprint for a Canadian Securities Commission* (June 7, 2006).

[9] Details about this initiative and its progress may be found on its official website, http://www.securitiescanada.org/index.html. Ontario has, thus far, resisted participating fully in the Passport System, favouring a more comprehensive reform of Canadian securities regulation nationally. Indeed, as recently as Wednesday June 14, Ontario's minister responsible for securities regulation, Gerry Phillips, reiterated the view that Ontario would agree to join the passport system, provided there were grounds to believe that doing so would more likely lead to the eventual creation of a national securities commission. See Janet McFarland, "Passport System Still Favoured, Except in Ontario" *Globe and Mail* (15 June, 2006) at B5. In its final report, however, the Crawford Panel noted that most of the participants in the roundtables the Panel had conducted, "do not view the Passport System and our proposed [Canadian Securities Commission] as diametrically opposed alternatives." (at p. 29)

[10] Functional regulation of the financial industry is often associated with the work of Nobel-prize winning Harvard economist Robert C. Merton. See, e.g., Merton, 1992.

regulatory expertise.[11] But, again, this paper will not retread this important yet familiar territory. Rather, a more modest attempt will be made here to review the characteristics of Canada's capital markets with a view to suggesting, at least in general terms, how the substance of Canadian regulation (whether ultimately administered by a single regulator or by multiple provincial and territorial regulators) might respond to foreign—especially U.S.—regulatory initiatives. However, such a review cannot on its own form the basis for detailed recommendations precisely because any regulatory change must take into account not only differences in market characteristics, but also differences in institutional arrangements, including differences in other areas of law that may affect how securities regulation will operate.

For example, to the extent that an active market for corporate control serves as a useful means of managerial discipline, a well thought-out securities regime would need to reflect the extent to which anti-trust and foreign investment laws facilitate or hamper hostile acquisitions. Similarly, corporate law proxy solicitation rules may significantly affect the feasibility of a proxy contest and so, again, influence the relative importance of the proxy contest as a managerial discipline.

The role and importance of investment funds (or mutual funds) in an economy also has profound significance on the appropriate structure of securities regulation both from the perspective of firm-level regulation, and from the perspective of investor protection.

Further, many of the observed characteristics that distinguish Canadian public companies may be linked to a complex interplay of institutional characteristics rather than to specific distinguishing attributes of Canadian securities laws and policies. The structure of pensions, which differs from jurisdiction to jurisdiction, may have also an effect on shareholding patterns. As Tirole has noted, for example, pension funds do not play a significant role in the ownership of corporations in France and Germany "because retirement benefits are publicly-funded on a pay-as-you-go basis (…in France)" and "pension funds are just a liability item on the firms' balance sheet and do not stand as independent investors (…in Germany)." (Tirole, 2006). In short, the distinguishing characteristics of a country's capital markets may reflect a complex web of historical, institutional and systemic features that make it unwise to draw hasty conclusions based on a comparison of a limited range of market characteristics. The need to be cognizant of pervasive systemic differences has been noted by Bratton and McCahery (1999).

[11] A careful consideration of this issue may be found in Poonam Puri, "Local and Regional Interests in the Debate on Optimal Securities Regulatory Structure", Research Study Prepared for the Wise Persons' Committee (October 7, 2003).

Accordingly, it would be ill-advised to suggest that a review of the distinguishing features of Canada's capital markets implies particular securities regulatory initiatives. Moreover, recent studies of Canadian securities markets[12] have included general regulatory recommendations for regulatory models that take account of certain features of Canada's capital markets, and it is unnecessary to repeat or summarize those recommendations here. However, it is possible to suggest the following several broad guiding principles that might inform Canadian responses to foreign securities regulatory initiatives, and Canadian securities reform more generally:

<u>Recommendation #1:</u> Scaled or proportional securities regulation should be considered both appropriate and necessary in the Canadian securities regulatory context.

The Canadian capital markets pose twin regulatory challenges for regulators: first, there is a need to ease certain formal requirements for the largest public companies - for which adequate investor protection already exists (as in the U.S. WKSI proposals). Yet regulators must also recognize that the relative cost of complying with regulatory burdens is much higher for the smallest companies, and may impede their competitiveness. In short, there is less need in principle to stringently regulate the largest companies, and less room, in practice, to stringently regulate the smallest companies. (The recent relaxing of the eligibility requirements for use of the Short Form Prospectus system, the cautious U.S. approach to implementing the Sarbanes-Oxley internal control rules for smaller issuers, and the Canadian response to many aspects of Sarbanes-Oxley provide examples.) However, the use of the concept of "venture issuers" as a proxy for smaller companies for which a lightened regulatory burden is appropriate should be revisited. It may be more important to ensure that firms of roughly the same size are regulated in the same way, a result that is not necessarily ensured by the "venture issuer" concept. It is noted that a regulatory model based upon firm size - measured by market capitalization - rather than regional or industrial sector considerations is consistent with the findings of an earlier study on market fragmentation completed in connection with the 2003 Wise Persons Committee Report.[13] The recent recommendations of the U.S. Advisory Committee on Smaller Public Companies offer an alternative method of sorting companies for this purpose, and that model should be carefully considered.

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[12] See, e.g., Five-Year Review Committee; Wise Persons Committee, *It's Time*. See also the recent Crawford Panel report, *supra,* footnote 8.
[13] See Douglas Cumming, Aditya Kaul & Vikas C. Mehrotra, "Fragmentation and the Canadian Stock Markets" (October 2, 2003), online at http://www.wise-averties.ca/reports/WPC_8.pdf.

<u>Recommendation #2:</u> Canadian regulators should consider the extent to which Canadian laws could reflect a more flexible and less rules-based approach to corporate governance than in the U.S., at least with respect to smaller Canadian issuers.

There are principled but competing views as to the value of enforcing rigorous disclosure and governance requirements. On the one hand, it is argued that such measures are critical to enhancing investor confidence, and so will help to reduce issuers' cost of capital. Conversely, it is argued that more flexible regulation will reduce issuers' costs and so provide competitive advantage. In this regard, it has recently been noted by the Advisory Committee on Smaller Public Companies that:

> "Some companies are either going dark or considering doing so;
> The London Exchange's Alternative Investment Market (AIM) for smaller public companies is gaining momentum;
> Foreign new listings in the United States during 2005 dropped considerably from the previous year;
> Foreign issuers are departing from the U.S. market (and their institutional investors are voting for their going offshore); and
> U.S. investors continue to invest in foreign securities even though the issuers are not subject to internal control requirements like those promulgated under Section 404."(at 41-42)

OSC Chairman David Wilson has recently suggested that the costs imposed on issuers in the U.S. by s. 404 of SOX was adversely affecting the U.S. market, noting that "of the 10 largest global IPOs last year, not one chose to register in the U.S."[14]

<u>Recommendation #3:</u> Canadian regulatory resources could usefully be directed towards enforcement of Canada's existing market manipulation and insider trading laws.

<u>Recommendation #4:</u> The regulatory emphasis on scrutinizing related-party and going private transactions reflected in OSC Rule 61-501 is sensible in principle. However, it is not entirely clear that the rules-based approach of Rule 61-501 offers the optimal means of regulating such transactions. Rule 61-501 should be carefully reviewed with a view to ensuring optimal protection

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[14] David Wilson, "Canadian Securities Regulation: Looking Forward to 2006-07" (Remarks at the Canadian Club of Montreal, Montreal, Quebec, May 29, 2006).

of minority shareholders within a framework that minimizes administrative hurdles and costs, especially for small issuers.

The protection offered to minority shareholders once a related party or going-private transaction has been initiated should be balanced against the effect an overly-constraining rule might have on deterring corporate changes of control which might offer overall greater benefits to Canadian investors. The Canadian market and regulatory environment evidently encourages or facilitates the accumulation of controlling blocks of shares (and therefore an effective means of monitoring corporate managers). Regulatory measures that weaken the incentives of investors to hold controlling blocks of shares (with a view to lessening the controlling shareholder/minority shareholder agency problems) without simultaneously enhancing mechanisms to reduce the shareholder/manager agency problem, risk imposing additional costs on public corporations with no corresponding benefit to minority shareholders.

<u>**Recommendation #5:**</u> **Consideration should be given to shifting regulatory emphasis away from the public offering process, and further toward issuer-based regulation.**

3. Introduction

> "Virtually every report, from that of the Kimber Committee to those of the corporate bar and securities industry, has grappled at an abstract level with the possibility that the structure of the Canadian economy could render solutions transported from other contexts less applicable to Canada. Nevertheless, this recognition has seldom (if ever) been followed up by a concrete analysis of the nature of Canadian distinctiveness and its consequences, rendering the appeal to Canadian distinctiveness more rhetorical than real."[15]

i. Overview

A significant body of academic literature has demonstrated how aspects of a country's legal and regulatory structure may support the development of its securities markets (e.g., Black, 2000). Legal and regulatory measures that facilitate disclosure and transparency and the protection of minority shareholders from corporate self-dealing and perhaps broader political influence have been found to affect the cost and patterns of corporate finance (e.g., Black, 2000; La Porta et al., 1998; Roe, 2000, 2004). Links have been drawn between observed differences in markets and in global patterns of share ownership, on the one hand, and jurisdictional differences in securities laws and in minority shareholder protections on the other, although the causal relationship between these observed phenomena has been questioned (Coffee, 2001).

Not every commentator agrees that the economic benefit of various mandatory features of U.S.-style securities regulation has been established (e.g., Stigler, 1964; Bentson, 1973; Romano, 2002; Choi, 2001). However, the more conventional view (conventionally confirmed, if by nothing else, by the persistence of complex U.S. market regulation) is that mandatory securities regulation aimed at enhancing market transparency and deterring market manipulation and insider trading is an integral part of well-functioning capital markets. All else equal, firms in jurisdictions that provide adequate protection in these areas should enjoy a lower cost of capital than rival firms in jurisdictions where investors do not enjoy such protections.

If similar regulatory mechanics may reasonably be expected to work equally well in different markets, then legal and regulatory convergence - whether formal or "functional" (see, e.g., Coffee, 1999) - may well be the inevitable consequence of increasing international competition between firms in product and

[15] Ronald J. Daniels & Jeffrey G. MacIntosh, "Toward a Distinctive Canadian Corporate Law Regime" (1991), 29 Osgoode Hall L.J. 863.

capital markets. But there are reasons for regulators to be cautious about too eagerly emulating a regulatory system developed in another jurisdiction, including the possibility that material differences between two jurisdictions' capital markets may cause a regulatory transplant to be dangerously incompatible. In particular, Bratton and McCahery (1999) have cautioned that borrowing regulatory ideas piecemeal from another system may be especially ineffective. Systems, in their view, are integrated, not modular; individual aspects of a foreign regulatory system, accordingly, cannot necessarily be usefully abstracted from the system as a whole.

Any hoped-for improvements in the design and implementation of Canadian securities regulation, then, ought to be sensitive to the distinguishing characteristics of Canada's capital markets, and mindful of how useful foreign regulatory initiatives can best be imported into Canada. There are at least two dimensions to this issue: first, it is necessary to assess the merits of any regulatory or legislative proposal on its own terms, irrespective of any considerations of jurisdictional "fit". Some foreign initiatives, in other words, may have their origins in political compromise, legislative expediency, or even panic, and may, with the benefit of more sober reflection than perhaps was possible in the foreign jurisdiction where they were originally crafted, be judged as simply too flawed to merit further consideration.

However, even if foreign initiatives appear initially to be based on coherent principles and to reflect reasoned and proportionate responses to serious problems, a second level of analysis is called for. This second level of analysis involves assessing the likely efficacy and propriety of the foreign initiative in light of relevant distinctions between Canada and the foreign jurisdiction. It is this second dimension to which this paper is directed. Section 3 of this paper seeks to document the distinctive characteristics of Canada's capital markets to provide as clear a picture as possible of the context within which Canadian securities rules must be crafted.

Section 4 of the paper then reviews a specific example of a Canadian response to foreign regulatory change - the sweeping American corporate governance reforms associated with the *Sarbanes-Oxley Act of 2002.* The goal here is to illustrate how an awareness of certain distinct aspects of Canada's markets appears to have influenced the form of Canadian governance rules adopted in response to *Sarbanes-Oxley*, and, from this admittedly narrow "case study" to seek to draw some tentative lessons about how Canadian securities regulation might best use American (and indeed other foreign) regulatory models going forward.

ii. Use by Canadian Legislators and Regulators of U.S. Models

In several important respects, Canada's capital markets are distinctly different from U.S. markets; but Canadian legislators and regulators regularly look to U.S. regulatory models when designing or amending Canadian capital market regulation. The reasons for doing so are usually thought to include:

- The perceived need to harmonize Canadian and U.S. capital market rules owing to the general integration of the Canadian and U.S. economies.
- The specific need to ensure that Canadian and U.S. regulations are similar given the significant number of Canadian public firms with shares that trade on both Canadian and U.S. markets, and the perceived need to enhance the credibility of Canadian firms seeking to access U.S. capital markets. The special access to U.S. markets made by possible by the Multi-jurisdictional Disclosure System[16] underscores this point.
- The need to avoid a perception that Canadian market regulation is lax, and, accordingly, unattractive for investors—domestic and foreign. This explanation usually accompanies the (now trite) observation that capital can easily move across borders. If Canadian regulation is, therefore, regarded as "inferior" (in some meaningful sense), capital will flee Canada, foreign investment will decline, and Canadian issuers, faced with a scarcity of investors, will incur higher costs of capital. The enhancement of Canada's regulatory reputation may also reflect a concern for what Black has dubbed "reputational spillover" (Black, 2000), a problem that could lead to an increased cost of capital even for Canadian companies choosing to list their shares on U.S. markets and so voluntarily submit to the same rules and listing requirements as large U.S. reporting companies.

The close economic relationship between, and geographic proximity of, Canada and the United States make the influence of American regulatory initiatives unsurprising. However, concern has frequently been expressed that the significance of American capital market regulation may be problematic in Canada because of the distinct characteristics of Canada's capital markets. Those distinct characteristics are discussed in detail in Part 4.

Whether Canada's economic interests are best served by pursuing uniformity with, or diversity from, U.S. regulation is a matter of considerable importance. One might note at the outset that Canadian financial

[16] See National Instrument 71-101 (1998), 21 OSCB 5104.

regulation has sometimes been most successful when it has departed most sharply from U.S. models. For much of the twentieth century, for example, U.S. banking laws were aimed at curbing the concentration of financial power by artificially limiting the size and operational scope of American banks. Whether this was or was not sensible political and economic policy is a matter about which reasonable people might well disagree. What is clear, however, is that - whatever the benefits of this regulatory approach - it came at a cost: namely, a fragmented system in which the failure of financial institutions was a frequent occurrence. Canadian legislators chose not to impose the same restrictions on Canadian banks. As a result, Canadian banks - unlike their U.S. counterparts - could operate nationally, grow to economically efficient size, hold broad-based investment portfolios, develop a national mortgage market and enjoy significantly higher levels of stability. As has often been noted, not one Canadian bank failed between the years 1925 and 1985. And while there were two bank failures in the late 1980s, both the failed banks were small western regional banks, neither in existence for more than 10 years, and representing in total less than 1% of total Canadian bank assets. Indeed, it could be argued that the health, size, and continuing independence of Canada's banks throughout the twentieth century was in no small part due to a decision *not* to follow American-style banking regulation.[17]

Should Canadian securities regulatory policy, likewise, be determined independently of U.S. models? More specifically, to what extent are the distinctive attributes of Canada's capital markets relevant to Canadian securities regulation?

[17] Of course many of the restrictions that fettered American banks for most of the past century have now been relaxed, U.S. banks are consolidating, and the competitive environment in which Canada's banks find themselves has changed materially.

4. Characteristics of Canada’s Capital Markets

i. Introduction

There is a now-familiar argument linking a country’s capital market characteristics to aspects of its legal system. In a country where protection of minority share interests are strong, one will find public corporations characterized by dispersed share ownership - corporations where, as Berle and Means observed more than 70 years ago - ownership is separated from control. A significant body of fairly recent scholarship argues that the development of public corporations with dispersed share ownership is evolutionary: such corporations are objectively superior to their more closely-held rivals and so the separation of ownership from control in a country’s leading corporations signals an important step forward in the economic development of that country. The longer delayed this important development is delayed, the slower the company’s economic development. Thus, the United States, where the separation of ownership and control occurred first, enjoys unparalleled economic strength. In the United Kingdom, by contrast, ownership and control did not separate until many years later, and U.K. economic performance lagged U.S. performance. Cheffins has summarized this line of argument thus: “Hence, while the Berle-Means Corporation ultimately did become dominant in the U.K., delay meant that market forces imposed a harsh and inevitable penalty.” (Cheffins, 2002)

This thesis has many variants and nuances, and, for that matter, has attracted its share of detractors. However, while there may be disagreement about the precise relationship between a jurisdiction's institutions and legal system and the characteristics of its firms and markets, it is clearly valuable to attempt to survey a jurisdiction’s market characteristics as a precursor to assessing regulatory policy. Accordingly, this part of the paper will discuss a number of the fundamental features of Canada’s capital markets, deferring a consideration of whether, or how, these characteristics should affect the form and structure of Canadian capital market regulation.

The principal features of Canada’s capital markets that will be outlined here are these:

- The size of Canadian capital markets
  An overview of Canadian publicly-traded corporations: their size (by market capitalization); their jurisdiction of incorporation; numbers of corporation by industry sector; and concentration of ownership.

ii. Size of Canadian Capital Markets

Canadian capital markets (specifically, Canada's equity markets) represent a very small fraction of world equity markets (although, given the size of Canada's economy, Canada's share of world equity markets is not disproportionately small.) According to figures published by the World Federation of Exchanges, in 2004 the total market capitalization of Canada's stock exchanges was about US$1.178 trillion. Total market capitalization for all WFE exchanges was about US$37.168 trillion. Thus, Canada's markets constituted about 3.17% of total market capitalization worldwide. To put this number in perspective, the NYSE's market capitalization as of 2004 was US$12.708 trillion (34.19%), the American Stock Exchange's market capitalization was US$83.302 billion (.22%), NASDAQ's market capitalization was US$3.533 trillion (9.51%), the London Stock Exchange's market capitalization was US$2.865 trillion (7.71%), and the Deutsche Borse's market capitalization was US$1.195 trillion (3.22%).

The relatively small size of Canada's capital markets has a number of implications. Canadian investors seeking to diversify their investment portfolios will need to invest in non-Canadian equities. Investors in any country might well be advised to diversify their portfolios geographically; but the case for holding foreign equities may seem especially compelling for Canadian investors whose home market represents such a small fraction of available equity investment. Of course, the home investment bias is a well-documented phenomenon internationally (e.g., French & Poterba, 1991) and, until recently, RRSP foreign-content restrictions further increased demand by Canadian investors for Canadian equities. With the recent relaxing of RRSP rules, however, concern has been expressed that the demand for Canadian equities, which historically have tended to trade at lower multiples than U.S. equities, might fall. In recent months, at any rate, the importance of this theoretical concern has been somewhat muted by the strong performance of Canadian equity markets.[18]

iii. Overview of Canadian Corporations

Though the total market capitalization of Canadian companies is small, the number of publicly-traded Canadian companies is relatively large.

The number of publicly-traded corporations in Canada is approximately 3500-4000. (The total number of exchange-listed issuers for which data is available as of December 31, 2005, is 3516.) The total number

[18] The Canadian markets, at the date of writing, have recently fallen back from their highest levels.

of Canadian corporations (both public and private) is approximately 2 million, of which the overwhelming majority are, not surprisingly, private (that is, not publicly-traded) corporations.

In Canada, business corporations may be incorporated under any one the thirteen provincial and territorial incorporation statutes or under the federal corporate statute, the *Canada Business Corporations Act* (CBCA). Apart from a relatively modest number of technical variations, (see, e.g., Gray & Halladay, 2002), the CBCA and most provincial and territorial corporate statutes (with the exception of the statutes in British Columbia, Quebec, Nova Scotia and Prince Edward Island) are broadly similar. The fact that it is possible in Canada to choose from among 14 different incorporating statutes suggests that competition for corporate charters, such as is observed in the United States, could have emerged in Canada. But there is no evidence that any such corporate charter competition exists in Canada, and various explanations of this difference have been offered by commentators (See Daniels, 1991; MacIntosh and Cumming, 2000).

Figure 2 shows, by jurisdiction of incorporation, the total number of corporations that were filers on Canada's System for Electronic Data Analysis and Retrieval (SEDAR) as of August 2005.[19] Figure 2 reveals that the number of *public* corporations in each jurisdiction differs from the overall pattern of incorporation indicated in Figure 1. Specifically, the statutes of British Columbia and Alberta appear to be "over-represented" among Canadian public companies incorporated under provincial legislation, and the proportion of public companies incorporated under the CBCA is significantly greater than the CBCA's overall "share" of Canadian incorporations.

[19] Under National Instrument 13-101, every issuer other than a foreign issuer that is required or otherwise proposes to file a document under securities legislation or "securities directions" (essentially policy statements in certain Canadian jurisdictions) must become an electronic filer and make filings under SEDAR. Foreign issuers may also elect to become electronic filers.

Figure 1: Pattern of Incorporation

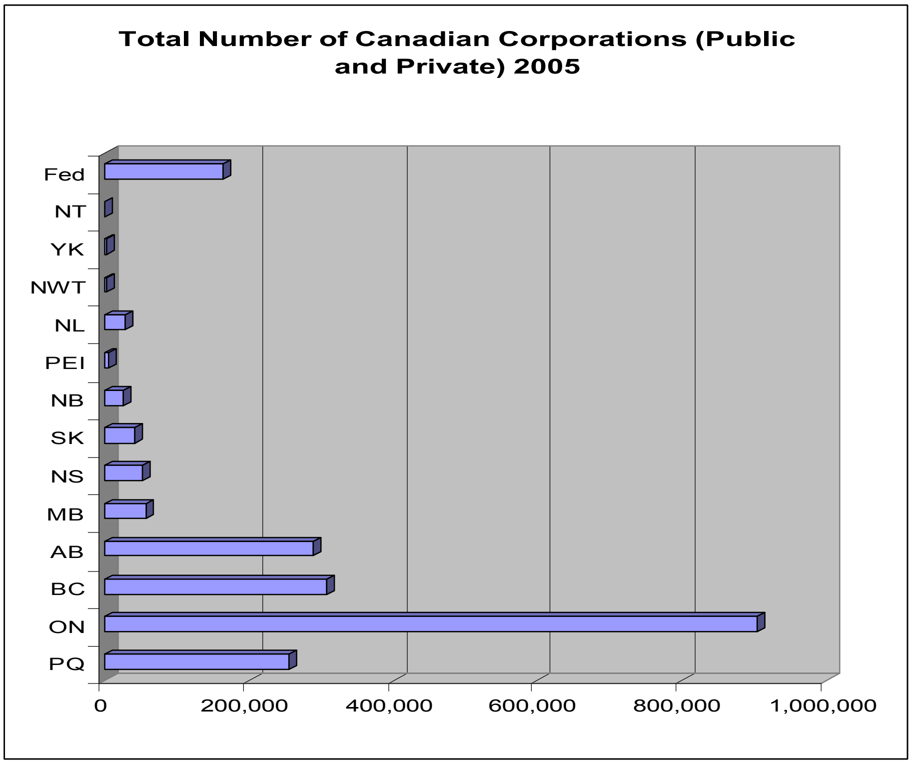
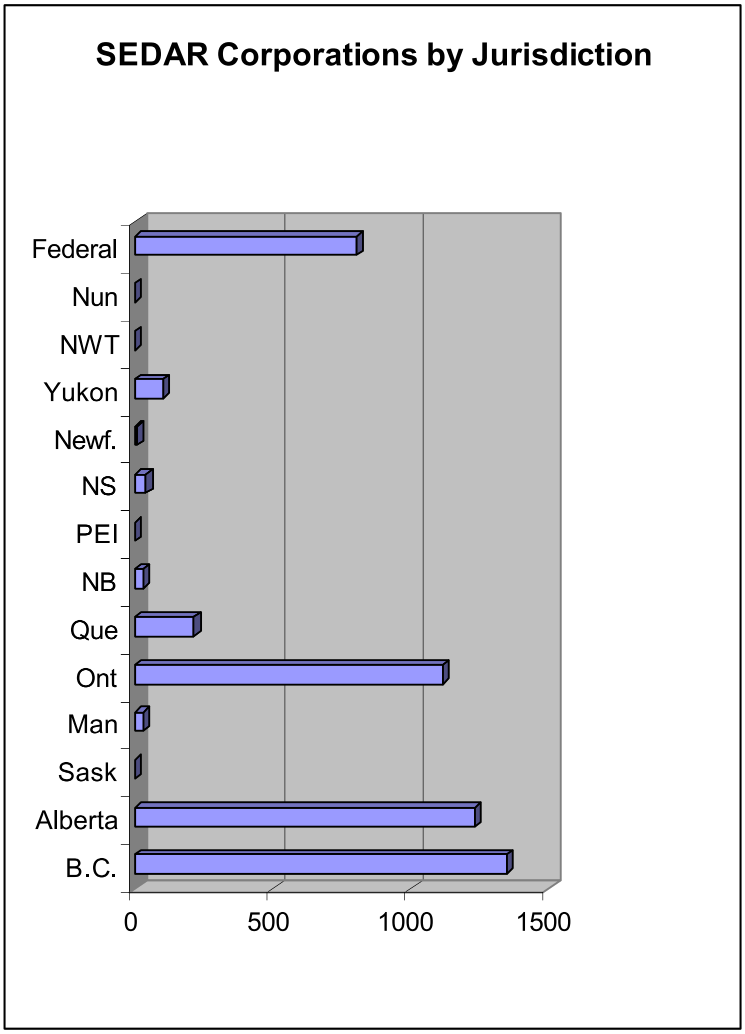


Figure 2: SEDAR Corporations by Jurisdiction



It has long been known that the CBCA is disproportionately favoured by larger Canadian public companies; and the significant number of publicly-traded corporations in British Columbia and Alberta evidently reflects the large number of junior mining and oil and gas ventures in those provinces, as discussed further below.

The preference of larger Canadian public companies for the CBCA may be suggestive that features of the federal CBCA regime are regarded as especially appropriate for such firms. However, it is possible that the most attractive aspects of the CBCA are features that cannot be replicated in Canadian provincial corporate statutes. For example, constitutionally only the CBCA can offer to corporations the right to carry on business, and to use their corporate name, throughout Canada. Further, it is sometimes suggested that CBCA incorporation is regarded as more "prestigious"[20] than incorporation under provincial statues, at least in the eyes of uninformed investors, perhaps especially in foreign jurisdictions.

a) Bifurcation of Canada's Public Companies: The Very Large and the Very Small

Companies Listed on Canada's Stock Exchanges

There are three recognized stock exchanges in Canada: The Toronto Stock Exchange (TSX), the TSX Venture Exchange, and the Canadian Trading and Quotation System, Inc. (CNQ).[21] As of December 31, 2005, there were 1535 issuers listed on the TSX and 2018 issuers listed on the TSX Venture Exchange. There are also 63 CNQ issuers.

The number of listed companies in Canada is high relative to the size of Canada's capital markets. One notes, for example, that there are about 9400 public companies in the United States,[22] though U.S. GDP is more than 10 times that of Canada's, and total market capitalization of U.S. listed firms, based on data compiled by the World Federation of Exchanges for 2004, was almost 14 times larger than the market capitalization of Canadian listed firms.

Indeed, the number of Canadian companies relative to its population appears to be the highest in the world—by a wide margin. Rajan and Zingales (2003) found that, in 1999, Canada had 130.13 listed companies per million people. This was more than double the figure for the next highest country (Australia: 64.91 per million) and more than four times the comparable figures for the United States (28.88) and the United Kingdom (31.11).

[20] Since the CBCA is a registration jurisdiction where incorporation is essentially "as of right", no informed person would regard CBCA incorporation as particularly prestigious. Moreover, there are no minimum capital requirements for a CBCA corporation, and even the minimal cost of incorporation is now lower than in the case of many provincial statues. If the CBCA were regarded as an especially rigorous statute, one could make the case that choosing CBCA incorporation were somehow more prestigious. But this seems, to say the least, somewhat improbable.

[21] CNQ was originally recognized by the Ontario Securities Commission as a quotation and trade reporting system (QTRS) on February 28, 2003. The OSC subsequently, on May 7, 2004, recognized CNQ as a stock exchange and, accordingly, rescinded CNQ's earlier recognition as a QTRS on that date.

[22] In Appendix E to the Final Report of the Advisory Committee on Smaller Public Companies to the U.S. Securities and Exchange Commission, Table 1, data was summarized for 9,428 companies which was based on information from the NYSE and AMEX as of March 31, 2005, and NASDAQ and the OTC Bulletin Board as of June 10, 2005.

Distribution of Large and Small Companies

Included within this large number of Canadian public companies are a great many companies with very small market capitalizations. In fact, there is a well-understood bifurcation of Canadian public companies: there are a modest number of firms that are very large (based on market capitalization); and a far greater number of firms with very low market capitalizations. Daniels and MacIntosh (1991) identified this distinction, dubbing the small, thinly-traded entities that constitute the majority of Canada's public companies, Canada's "second market". Although it is well-understood that may of Canada's smallest public companies trade on the TSX Venture Exchange - an exchange that defines itself as an exchange for small and medium-sized issuers—the distribution of companies listed on the TSX, Canada's senior equities exchange, also exhibits this large firm/small firm bifurcation. As Figure 3 illustrates, the 100 largest companies (by market capitalization) listed on the Toronto Stock Exchange account for over 70% of the market capitalization of all TSX-listed companies. Similarly, Figure 4 illustrates that fewer than 20% of the largest TSX companies account for almost 85% of the TSX's total market capitalization. By contrast, as Figure 5 shows, the 1000 smallest TSX-listed companies account for less than 5% of the total market capitalization of TSX-listed issuers.

Figure 3: Market Capitalization of the Largest Companies on the TSX

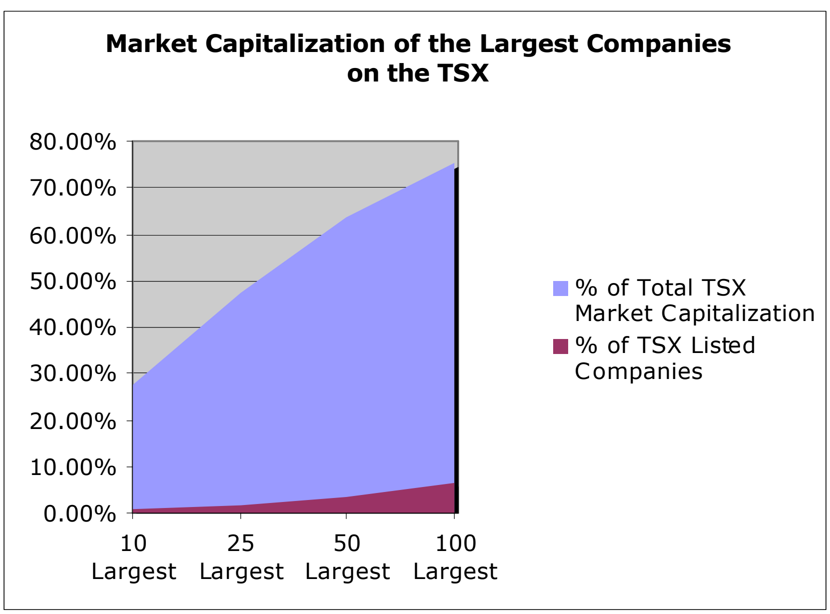


Figure 4: Percentage of Total Market Capitalization Represented by the TSX's Largest and Smallest Companies

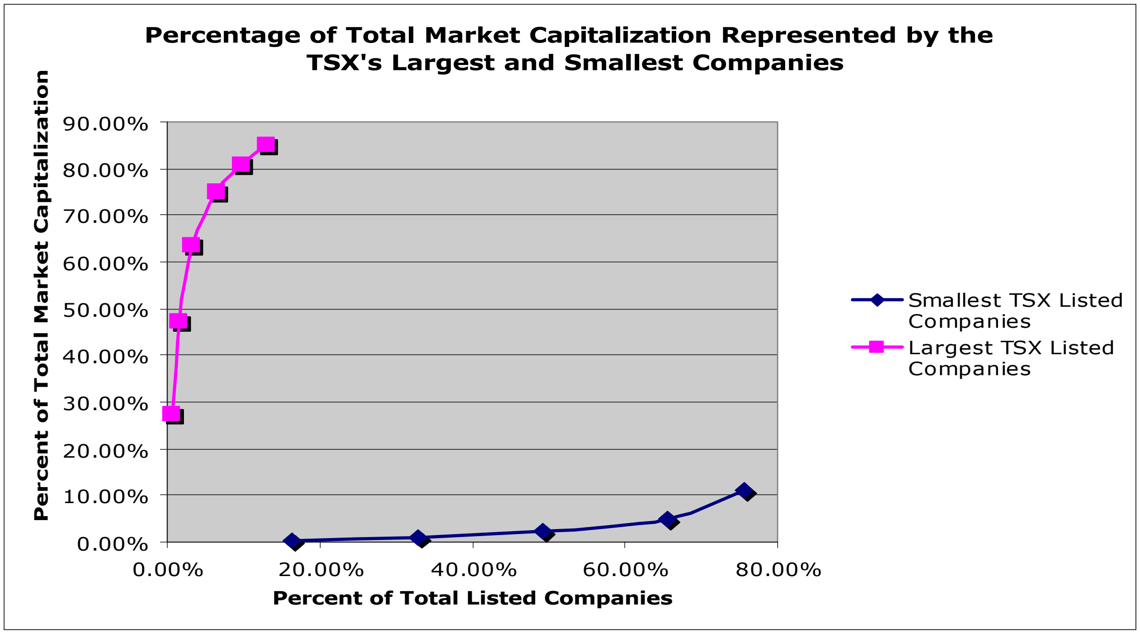
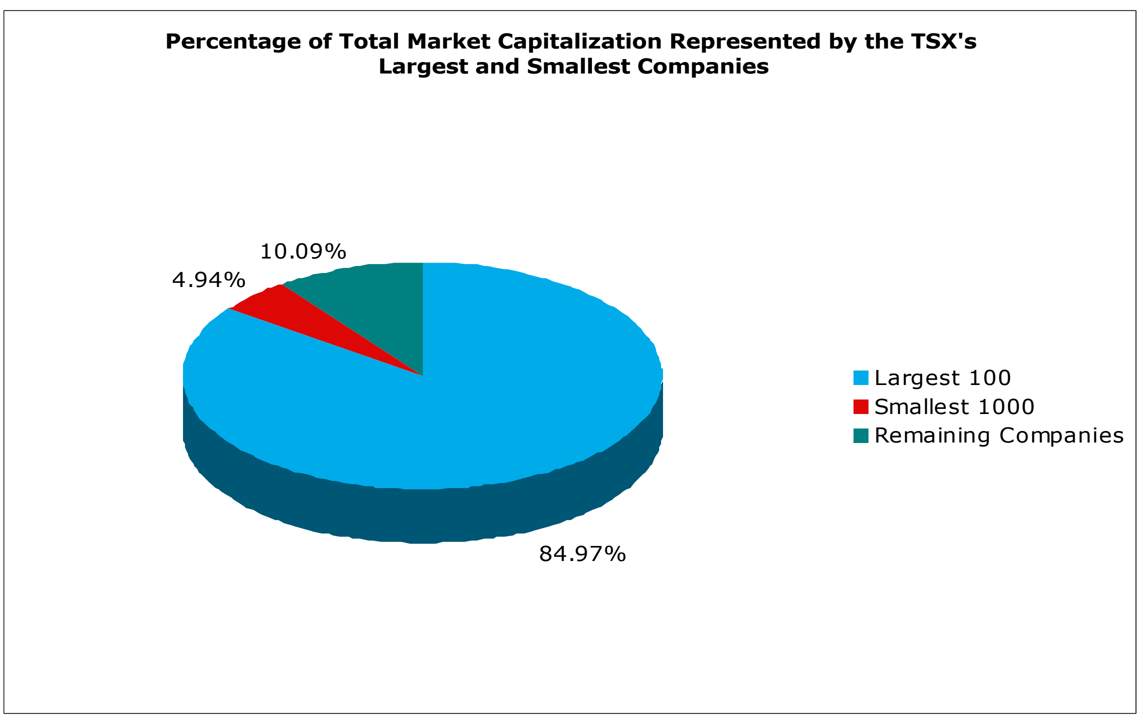
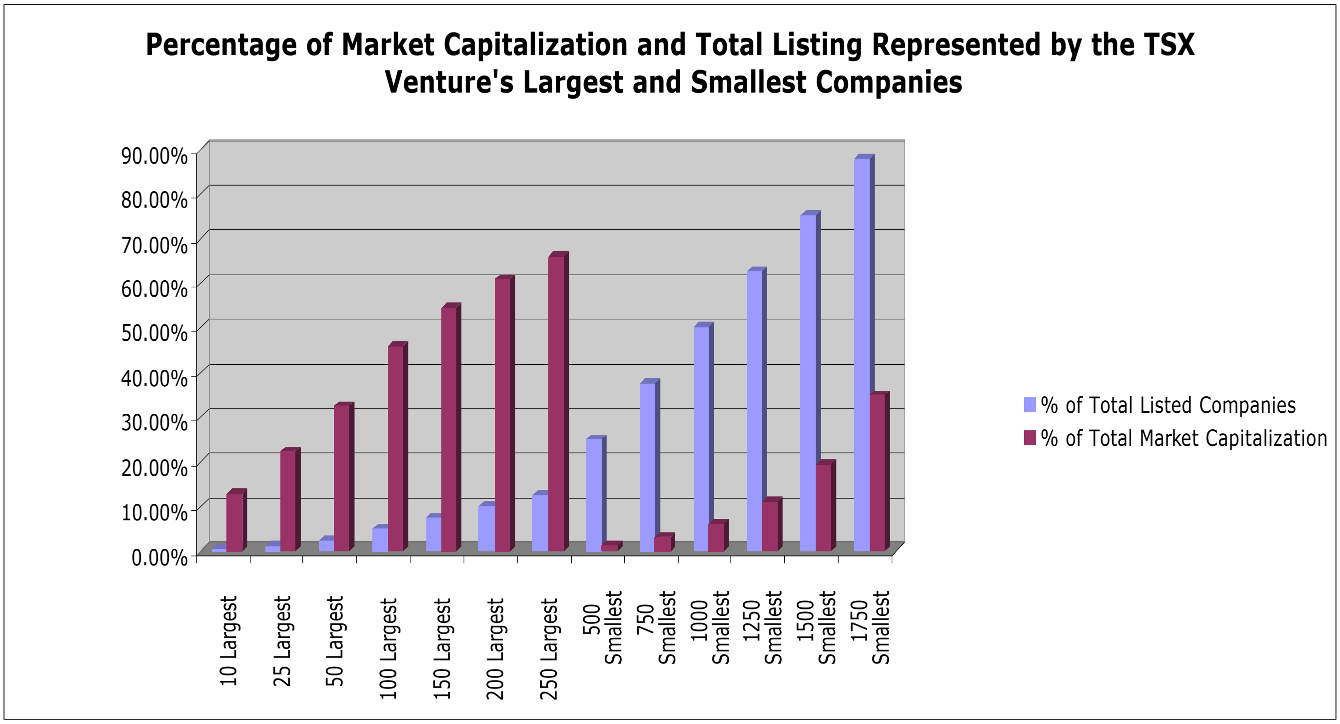


Figure 5: Percentage of Total Market Capitalization Represented by the TSX's Largest and Smallest Companies



A large company/small company bifurcation also prevails with respect to firms listed on the TSX Venture Exchange, although it is somewhat less dramatic because, predictably, larger companies listed on the TSX Venture Exchange are in short supply. As Figure 6 illustrates, the largest 150 TSX Venture Exchange companies account for just over 54% of total market capitalization, and the largest 250, more than 65%, while the smallest 1250 account for just over 11% of total market capitalization.

Figure 6: Percentage of Market Capitalization and Total Listing Represented by the TSX Venture's Largest and Smallest Companies



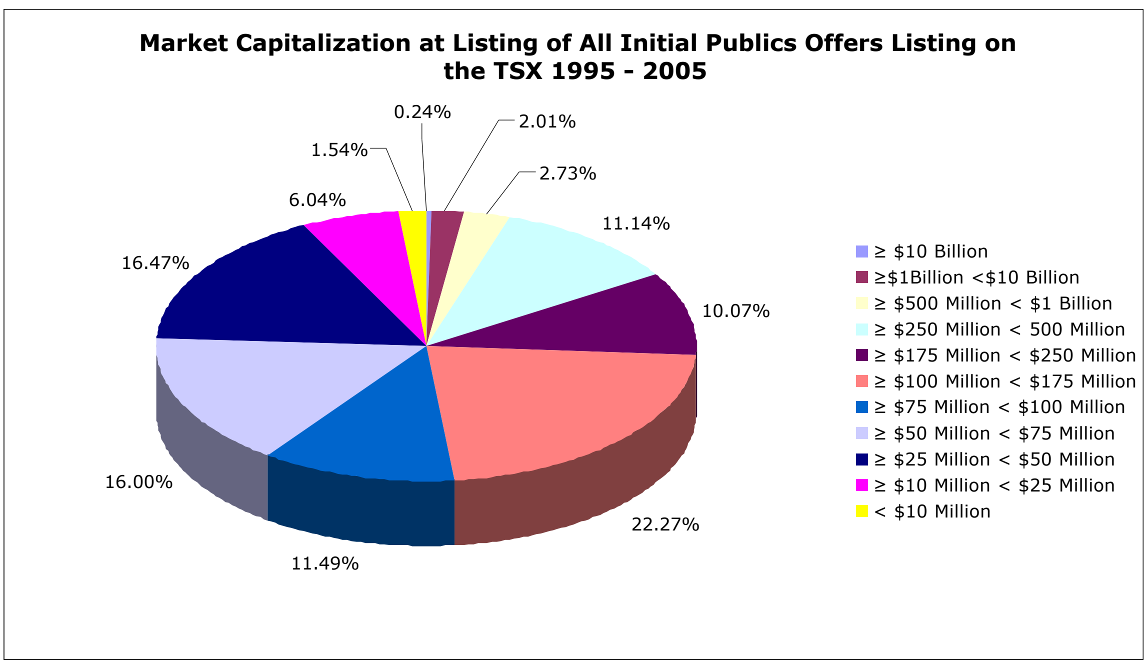
While the TSX is Canada's "senior" equities exchange, the 100 largest TSX Venture Exchange companies (based on data from December 2005) are in fact larger, in terms of market capitalization, than over 500 of the TSX-listed companies (i.e., almost 1/3 of the total TSX companies.) The largest 63 TSX Venture companies each had market capitalization of more than $100 million, larger than some 631 TSX-listed companies. Thus, although it might seem reasonable to generalize that TSX Venture Exchange companies are smaller than TSX listed companies, this generalization is not wholly accurate.

Size of Canadian Companies at time of IPO

To the extent that Canada's capital markets are characterized by a relatively greater proportion of very small companies, there are two obvious inferences: first, that consolidation of Canadian firms may not have been as significant in Canada as in some other jurisdictions; and, second, that Canadian firms choose to go public at an earlier stage in their development than firms in some other jurisdictions, especially the United States. No attempt has been made to examine the frequency of consolidation of Canadian firms. However, Figure 8 does show a breakdown of the size of companies undergoing initial public offerings on the TSX during the 10 year period 1995-2005. This figure reveals that over half of the companies that went public during this period had a market capitalization, at the time of the IPO, of less than $100 million, and fewer than 5% of such companies had a market capitalization of more than $500 million.

The willingness and ability of companies in a jurisdiction to complete IPOs is a feature often associated with strong minority shareholder protections.

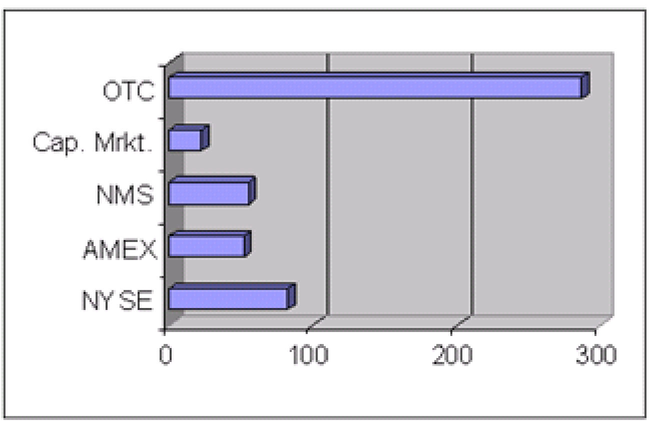
Figure 8: Market Capitalization of Listing of All Initial Public Offers Listing on the TSX, 1995-2005



Listing of Canadian Companies on U.S. Exchanges

Large Canadian companies may be more directly affected by U.S. governance rules and practices than larger issuers in many other non-U.S. jurisdictions. Many of the largest Canadian issuers on the TSX are also listed on U.S. exchanges. Specifically of the largest 50 Canadian TSX issuers, 33 are also listed on the New York Stock Exchange. Of the largest 100 Canadian TSX issuers, 51 are also listed on the New York Stock Exchange. (About 86 TSX issuers in total are cross-listed on the NYSE.) Some smaller TSX-listed companies are also listed on U.S. markets. 39 TSX-listed companies are listed on the Nasdaq National Market, 12 are listed on the Nasdaq Capital Market (formerly the Nasdaq Small Cap Market) and about 42 trade on the American Stock Exchange. A number of non-TSX listed Canadian companies are also registered in the United States. The following Figure 9 summarizes details, by market, of Canadian companies registered in the United States as of 2004.

Figure 9



The market capitalization of all TSX-listed companies that are cross-listed on U.S. exchanges or otherwise trade in U.S. markets constitutes just over 50% of the TSX's total market capitalization.

Canadian companies choosing to list their shares on American exchanges are, of course, subject to the rules of those markets and - with limited exceptions for foreign private issuers - those rules are essentially the same as those to which U.S. issuers are subject.

Not surprisingly, Canadian firms comprise a disproportionately large percentage of foreign private issuers in the United States. The SEC reported that of the 1,240 foreign companies registered and reporting with the SEC as of December 31, 2004, 497 (40%) were Canadian companies. The number of Canadian companies was more than four times larger than the number of companies from the second most-represented jurisdiction (the United Kingdom - 107 firms, or 8.6%). Indeed, there are more Canadian companies so registered than there are firms so registered from the next 12 countries combined.[23]

Canadian issuers also list on other foreign exchanges. For example, as of March 2006, 48 Canadian companies were listed on the London Stock Exchange, of which the vast majority (36) were listed on the more "flexibly regulated" Alternative Investment Market ("AIM"). Of these 48 companies, 32 are also TSX-listed issuers, and 4 are TSX Venture Exchange-listed issuers.

Distribution of Companies by Market Capitalization: Canada/U.S. Comparison

To place the size distribution of Canadian companies in context, it is illuminating to compare the Canadian information with data recently compiled in connection with the April 23, 2006 *Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission*.[24] The Advisory Committee has proposed dividing smaller U.S. public companies into two classes for certain regulatory purposes: micro-cap companies, those "whose outstanding common stock (or equivalent) in the aggregate comprises the lowest 1% of total U.S. equity market capitalization,"[25] and small-cap companies "whose outstanding common stock (or equivalent) in the aggregate comprises the next lowest 5% of total U.S. equity market capitalization."[26] Using those parameters, the Advisory Committee determined that the market capitalization cutoff for micro-cap companies in the U.S. market would be US$128.2 million; small-cap companies would be those with market capitalizations in the $128.2 - $787.1 million range. Using this measure, the drafters of the report note, 52.6% of U.S. public companies would be micro-cap companies, and an additional 25.9% would be small-cap companies.

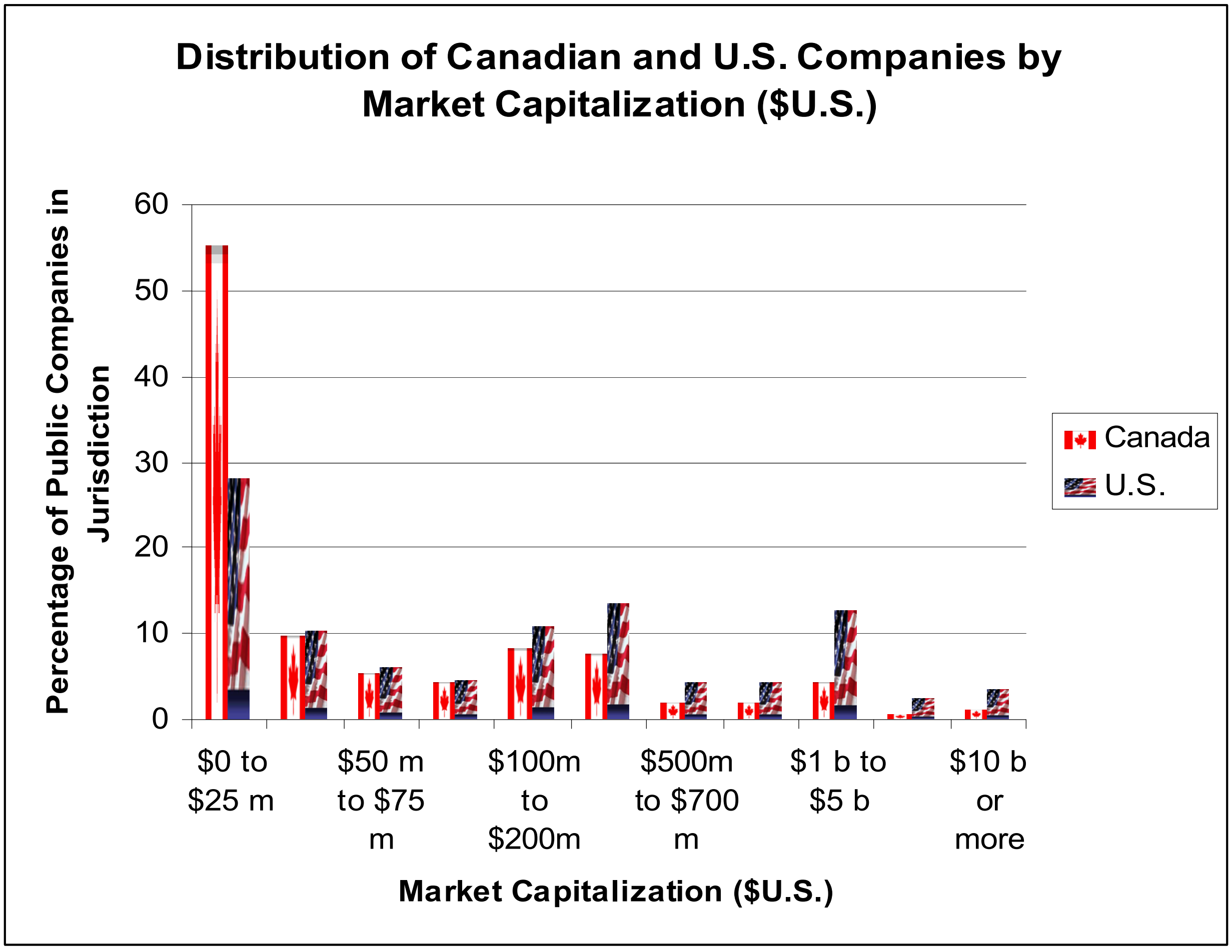
Small-cap and micro-cap companies certainly comprise a significant proportion of all U.S. public companies - approximately 78.5% in fact.[27] However, tellingly, over 50% of American public companies have a market capitalization of over US$100 million, while just over 25% of Canadian companies have a

[23] Office of International Corporate Finance, Division of Corporation Finance, U.S. Securities and Exchange Commission, *Number of Foreign Companies Registered and Reporting with the U.S. Securities and Exchange Commission December 31, 2004.* Available online at <http://www.sec.gov/divisions/corpfin/internatl/foreignsummary2004.pdf>.
[24] Available online at http://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf.
[25] *Ibid.,* at p. 5.
[26] *Ibid.*
[27] *Ibid.*

market capitalization of over US$100 million. Moreover, if the Advisory Committee's benchmarks, converted into Canadian dollars, were applied to Canadian public company data, about ½ of the companies on the TSX, Canada's senior equity exchange, and about 98% of the companies on the TSX Venture Exchange would be considered "micro-cap companies." Moreover, all but the largest 245 companies on the TSX, and all companies listed on the TSX Venture Exchange (other than the micro-caps) would be small-cap companies.

Figure 10 illustrates how Canadian and U.S. companies compare in terms of market capitalization.

Figure 10: Distribution of Canadian and U.S. Companies by Market Capitalization (US$)



The Advisory Committee was, however, not purporting to apply "standardized" measures of micro-cap and small-cap companies. Rather, the Committee arrived at its suggested dollar thresholds by defining as "micro-cap" as the smallest 1% and "small-cap" companies as the next smallest 5% of U.S. companies. Accordingly, if Canadian companies were categorized using this classification scheme, then a "micro-cap" company in Canada would be a company with a market capitalization of about $36.6 million (that is, the total market capitalization of all listed companies with a market capitalization of less than $36.6 million represents about 1% of total Canadian equity market capitalization.) Similarly, the small-cap market cut off would be about $256.5 million (that is, the total market capitalization of all listed companies with a market capitalization of less than $256.5 million represents about 6% of total Canadian equity market capitalization.)

The number of listed companies in the micro-cap category, using this measure, would be approximately 2,100 (or about 59.7% of listed companies for which data is available). The average market capitalization of these micro-cap companies would be about $8.846 million, and the median market capitalization would be about $5.116 million.

The total number of smaller Canadian companies (both micro-cap and small-cap) using these measures would be about 2,954, or about 84% of all listed companies for which market capitalization data is available.

Some useful comparisons may be made between the distribution of large and small companies in the Canadian and U.S. markets. About 52.6% of U.S. public companies comprise the lowest 1% of total U.S. market capitalization, whereas about 59.7% of Canadian companies comprise the lowest 1% of Canadian market capitalization; 78.5% of U.S. public companies comprise the lowest 6% of U.S. market capitalization, compared with about 84% of Canadian companies. This comparison reveals that the proportion of Canadian companies that fall within these micro-cap and small-cap categories is somewhat larger than in the United States, but, more significantly, that the Canadian companies are substantially smaller in absolute dollar terms. The substantial size difference between Canadian and U.S. public issuers becomes even more significant when one compares the average and median market capitalization of small companies within various bands of market capitalization.[28] Accordingly, the suggestion that the

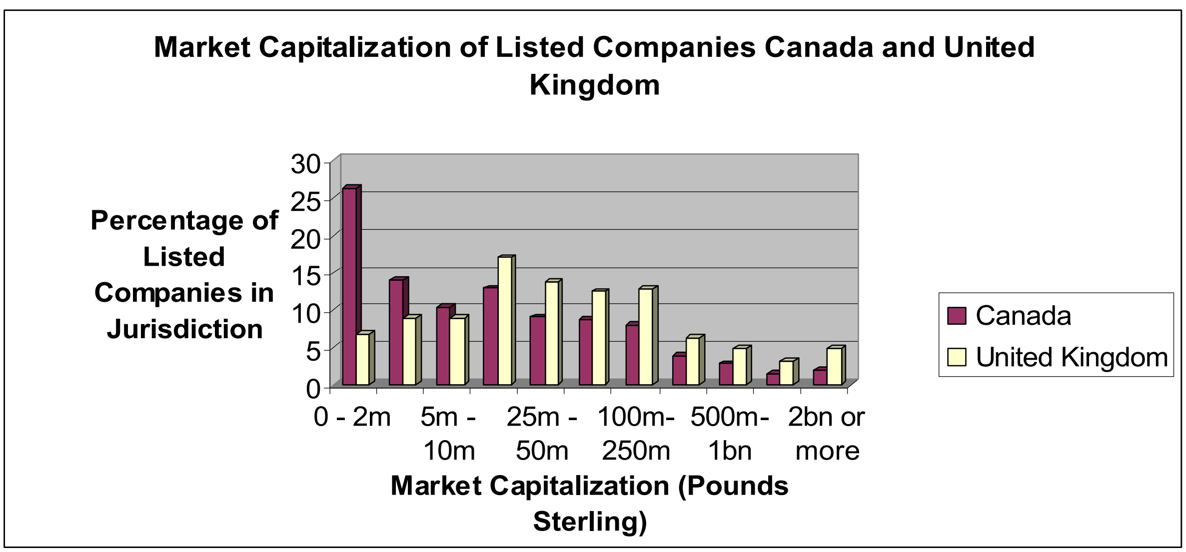
[28] It is noted that in two submissions to the Task Force—one from The Canadian Listed Company Association, and one from Stephen Sibold—different figures are given with respect to the percentage of Canadian companies with a market capitalization of less than U.S. $25 million. Specifically, both of these submissions states that about 71% of all publicly-listed Canadian companies would fall into this category. It is unclear what the source of this data discrepancy is, although there are at least two possibilities. First, the two submissions may have been using earlier TSX data that did not reflect the higher market capitalizations of many Canadian companies as of December 31, 2005. Second, their figures may have been calculated using a different Canadian/U.S. dollar exchange rate. Indeed, Mr. Sibold's submission indicated the use of a U.S./Cdn. Dollar exchange rate of about 1.2 ("US $25 million…translates roughly into C$30 million.") Such a rate reflects the value of the Canadian dollar in the summer of 2005; but the Canadian dollar has subsequently risen in value against the U.S. dollar and the rate used for calculations in this paper was approximately 1.16.

majority of U.S. public companies may be considered - by U.S. standards - to be small-cap, just as the majority of Canadian public companies may be considered - by Canadian standards - small-cap, obscures the profound difference between U.S. small- and micro-cap public companies and their much smaller Canadian counterparts.

Accordingly, lighter or more flexible regulation that may be considered appropriate for U.S. micro-cap and, more particularly, small-cap companies could, potentially, still prove overly burdensome for significantly smaller Canadian small-cap companies.

It is also illuminating to contrast the relatively large number of small public companies in Canada with data from the United Kingdom. Figure 11 compares the distribution by market capitalization of U.K. companies listed on the LSE Main Market and AIM with Canadian TSX and TSX Venture Exchange companies. Of particular note is the extent to which the percentage of Canadian public companies in the smallest bracket (market capitalization of less than the Canadian dollar equivalent of £2 million) is almost 5 times larger than the percentage of U.K.-listed companies in the same bracket.

Figure 11: Market Capitalization of Listed Companies, Canada and United Kingdom



It is clear from even this limited canvass of the data that features of the Canadian securities market—including, presumably, existing Canadian securities law and regulatory policies—have been conducive to the formation of a disproportionately large number of very small Canadian public companies.[29] Whether this outcome was the intended result of legislators and regulators, or occurred for reasons unrelated to - or even in spite of - Canada's existing regulatory framework, it is clear that, going forward, regulatory initiatives must be structured to take account of this undeniably significant feature of Canada's capital markets landscape.

b) Trusts and Corporations

It is also worth noting that a distinct feature of Canada's capital markets is the relative importance of trusts, as opposed to corporations. Over 400 of the listed issuers on the TSX are trusts. This is a fact of which Canadian securities regulators are well aware,[30] and which frequently calls for regulation by analogy since trusts are not subject to the same statutorily prescribed governance structure as corporations. Indeed, several leading take-over bid defence cases in Canada have arisen in the context of publicly traded trusts, rather than publicly traded corporations.[31] The investor-protection goals of securities regulation are often assumed to operate in tandem with standard Canadian corporate law shareholder remedies (including, among others, the corporate law oppression remedy). Accordingly, the fact that a material number of Canadian public issuers are not in fact incorporated entities should inform governance-related regulatory measures. Such measures may need to be evaluated on a "free-standing" basis, since it cannot necessarily be presumed that all investors will also have recourse to traditional corporate law shareholder protections.

Canadian securities regulators have, not infrequently, initiated regulatory reforms in the interests of investor protection that have strayed into areas traditionally regarded as matters of internal corporate

[29] The number of Canadian public companies appears to be disproportionately large relative to the size of Canada's population when compared not only with the United States and the United Kingdom, but also with other (perhaps all other) countries in the world. Rajan and Zingales examined international statistics in 1999 for 24 countries, which revealed that the number of listed companies per capita in Canada was significantly higher than in any of the other 23. In fact, the number of listed companies in Canada was more than twice that of the next highest country (Australia), more than 6 times greater than in Japan, more than 4.5 times greater than in the United States, more than 4 timers greater than in the U.K., more than 5 times greater than in Spain, more than 20 times greater than in Italy, and more than 10 times greater than in Germany. See Rajan and Zingales (2003). Indeed, it is not unfair to say that an unusually large number of publicly traded companies may truly be regarded as an example of "Canadian exceptionalism."

[30] See, e.g., CSA Staff Notice 51-301, "Conversion of Corporate Issuers to Trusts" (1997), 20 OSCB 5134; and National Policy 41-201, "Income Trusts and Other Indirect Offerings" (2004), 27 OSCB 9685.

[31] See, e.g., *Re Royal Host Real Estate Investment Trust* (1999), 22 OSCB 7819; *Primewest Energy Trust v. Orion Energy Trust* (1999), 238 A.R. 193 (Alta. Q.B.); *Rio Tinto Canadian Investments Ltd. v. Labrador Iron Ore Royalty Income Fund (Trustee of)* , [2001] O.J. 3499 (C.A.).

law.[32] Perhaps the most obvious example of this apparent regulatory "creep" has occurred in the area of proxy solicitation rules. In many instances, the expansion of securities regulation into traditional areas of corporate law is thought to reflect a perceived need to fill a legislative or regulatory vacuum: amending corporate law is a slow process which is rarely a top priority for legislatures, whereas well-staffed securities commissions armed with rule-making powers are much better positioned to respond to changing market conditions. However, when securities regulators assume the role of de facto corporate legislators there is a danger of introducing duplicative or even contradictory rules.

The concern about the dangers of regulatory overlap, however are typically expressed in the context of incorporated entities. In the case of reporting issuers that are trusts, there may well be a wider scope for mandatory securities rules. In the absence of a national Canadian securities regulator, it may be that the stock exchanges could play an important role in ensuring consistent rules for such non-corporate entities with publicly traded securities.

c) Breakdown by Industry

The Canadian market is often associated with natural resources and commodities. In particular, it is often suggested that Canada's mining and oil and gas companies are significant internationally. One notes that the TSX Venture Exchange describes its listed companies as "active primarily in the mining, oil and gas, manufacturing, technology and financial services sectors,"[33] and further identifies biotechnology, oil and gas, mining, and technology as the "four main sectors that are represented on the exchange."[34]

Available data provides support for the view that certain industry sectors represent a dominant proportion of Canada's equity markets, and that sectoral dominance is observed on both of Canada's two principal equity exchanges.

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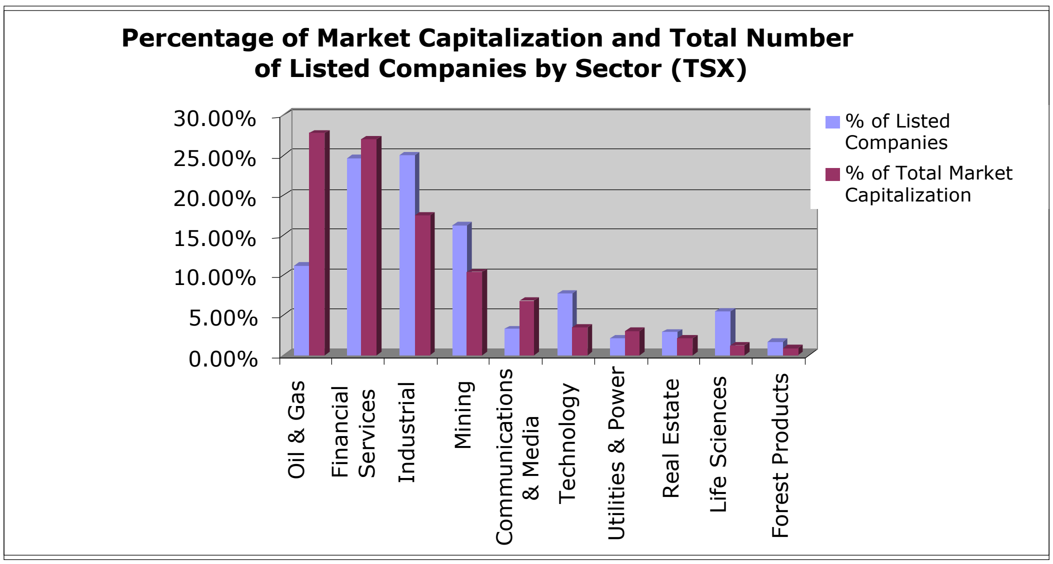
[32] For a discussion of this issue see Philip Anisman, "Regulation of Public Corporations: The Boundaries of Corporate and Securities Law" in *The Future of Corporation Law Issues and Perspectives*, Papers Presented at the Queen's Annual Business Law Symposium, 1997 (Toronto, Carswell, 1999) 63, in which the author argues that "there is no bright line, indeed no *a priori* line at all, between corporate and securities law and regulation governing the activities of public corporations." (at 88). Others have suggested that the indirect modification of corporate law by securities regulators may not be entirely benign. See, e.g., M.R. Gillen, "Increasing Overlap between Securities Regulation and Corporate Law Has Consequences" (1996), 4 Corporate Financing 30; Patrick Moyer, "The Regulation of Corporate Law by Securities Regulators: A Comparison of Ontario and the United States" (1997), 55 University of Toronto Faculty of Law Review 43.
[33] See TSX Group website, online at <http://www.tsx.com/en/aboutUs/cdnx/index.html.>
[34] Ibid.

Toronto Stock Exchange

As the following Figure 12 indicates, listed companies in three sectors - Oil and Gas, Financial Services and the Mining Sector - collectively account for just over 65% of total TSX market capitalization. (A more detailed breakdown of TSX companies in the Oil and Gas Sector, the Financial Services Sector, the Industrials Sector, and the Mining Sector can be found in Appendices A, B, C, and D respectively.)

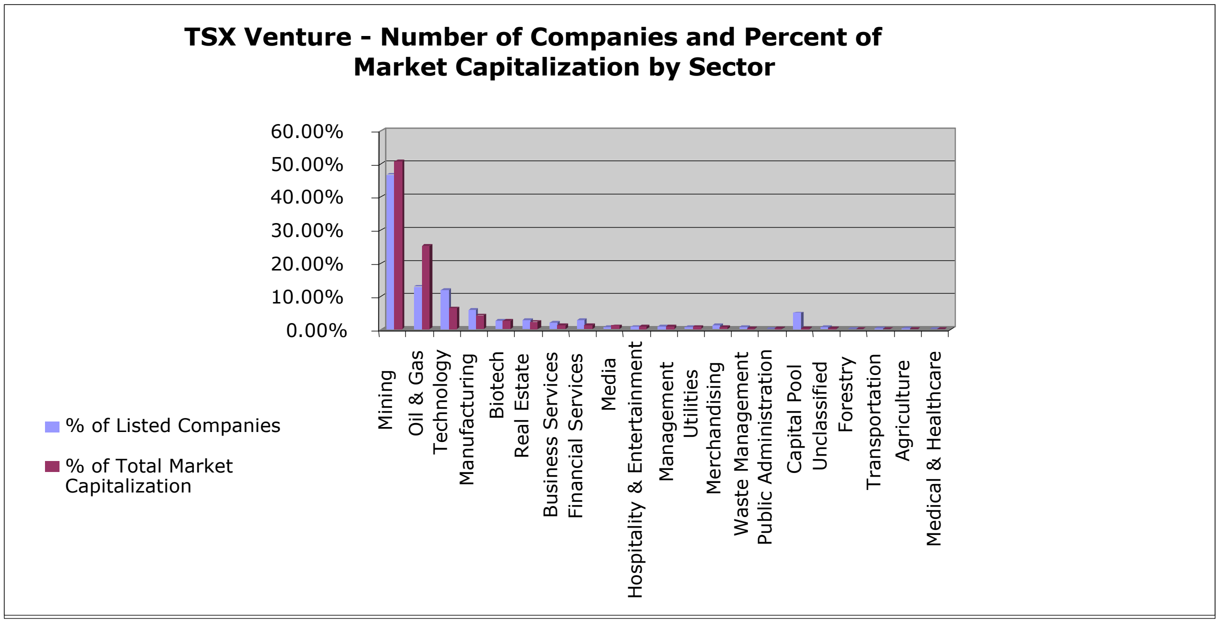
Figure 12: Percentage of Market Capitalization and Total Number of Listed Companies by Sector (TSX)



TSX Venture Exchange

The dominance of mining and oil and gas is more pronounced on the TSX Venture Exchange. As Figure 13 shows, mining companies alone account for more than 50% of the TSX Venture Exchange Market capitalization, and mining and oil and gas, collectively, represent more than 75% of total TSX Venture Exchange market capitalization. The third-largest sector, technology, accounts for about 6.41% of market capitalization, meaning that these three sectors, in the aggregate, account for over 80% of the TSX Venture Exchange market capitalization.

Figure 13: TSX Venture – Number of Companies and Percent of Market Capitalization by Sector



A more detailed breakdown of TSX Venture Exchange Companies in the Mining Sector, the Oil and Gas Sector, the Technology Sector, the Manufacturing Sector, the Financial Services Sector and the Biotechnology Sector is found in Appendices E, F, G, H, I, and J, respectively.

d) Capital Pool Companies

One interesting recent capital market innovation in Canada is the Capital Pool Company.[35] The Capital Pool Company concept was an innovation pioneered by the predecessor to the TSX Venture Exchange. A capital pool issuer is permitted to issue and file a prospectus, and obtain an exchange listing, before it has commenced carrying on business. After completing this public financing, the capital pool company has 18 months within which to complete a "qualifying transaction." There are now about 100 capital pool companies listed on the TSX Venture Exchange, but their combined market capitalization ($110,926,983 as of December 2005) constitutes less than 1/3 of 1% of the TSX Venture Exchange total.

e) Ownership of Canadian Corporations

The ownership structure of a jurisdiction's public corporations has attracted considerable scholarly attention and has been the subject of complex theory and speculation. Following, in particular, the work

[35] See, TSX Venture Exchange, Policy 2.4.

of La Porta *et al.*, it is convenient to classify jurisdictions into two broad groups, based on the prevalence of publicly traded corporations with certain patterns of share ownership: dispersed share ownership systems; and blockholder systems.

Dispersed share ownership tends to be found in jurisdictions with superior protection of minority shareholder rights (typically common law jurisdictions); concentrated share ownership (or blockholding) tends to be found in jurisdictions with weaker minority shareholder protection and, accordingly, greater scope for controlling shareholders to extract private benefits of control (typically civil law jurisdictions, especially those that trace their roots to the Napoleonic Code).

The prevailing view is that strong minority shareholder protection is a pre-condition to the development of dispersed share ownership (the separation of ownership and control), and that jurisdictions which provide such protections and so facilitate widely-dispersed share ownership will outperform blockholder jurisdictions where blockholders have a greater incentive to maintain a control block which they can subsequently sell - as a block - to another buyer, rather than to "sell" control to the market itself. (Coffee, 2001; Bebchuk, 1999) Over time, it is said, forces of international competition will inevitably lead to convergence. On this theory, strong legal protection for minority shareholder interests is a necessary pre-cursor to the separation of ownership and control. However, a number of commentators have advanced theories that depart from this prevailing view in whole or in part. Professor Coffee, for example, has suggested that, to the contrary, strong legal protection of minority shareholders is not a *pre-condition* for the development of liquid securities markets, but rather dispersion of ownership in the United States occurred first, and so created a constituency of minority shareholders that demanded, and ultimately obtained, minority shareholder protections. (Coffee, 2001) As Professor Coffee puts it, "By no means does this imply that stronger legislation protecting minority [shareholder] rights is not desirable, but historically this step has followed, rather than preceded, the initial growth of the equity market." (Coffee, 2001)

Nor is there universal agreement as to the objective superiority of dispersed share ownership. Demsetz and Villalonga (2001) for example, have challenged the relationship between ownership structure and firm performance. This relationship raises a complex economic question which is beyond the scope of this paper (and the competence of this author). It is only to be noted here that considerable significance has been attached to observed corporate ownership patterns, and, while the precise significance of observed differences in such patterns is best left for others to explore, it is worth briefly surveying the patterns of ownership of Canadian public corporations. This paper does not, however, purport to offer a conclusive explanation as to why Canada's capital markets are characterized relatively more by controlled corporations than by corporations with widely-dispersed shareholders such as those more typically observed in U.S. and U.K. markets.

A significant number of Canadian public companies have large shareholders. In some cases those shareholders hold legal voting control (50%+ of the outstanding voting shares). In other cases, though they may not hold enough shares to constitute legal control, they nevertheless own blocks of voting shares sufficient to make them "control block persons" within the meaning of provincial securities laws (i.e., 20%+ of the outstanding voting shares) [36] or blocks large enough, in the absence of any other major shareholder, to exercise a significant level of de facto control and to render them "insiders" within the meaning of provincial securities laws (i.e., 10% + of the outstanding voting shares.)[37]

According to TSX data, more than ¼ of the largest 300 TSX-listed issuers have a controlling shareholder.[38] Based on inter-corporate ownership information compiled by Statistics Canada, it appears that 41 of the 100 largest Canadian corporations on the TSX have a single shareholder with at least a 10% stake; of those, 30 have a shareholder with at least a 20% stake; and, of those, 21 have a controlling shareholder.

There is also a widespread practice among Canadian public companies of issuing restricted voting or dual-class shares so as to provide to certain shareholders voting rights disproportionately greater than their equity interests in the corporation. It is estimated that between 20-25% of companies listed on the TSX have some kind of dual-class share structure.[39] The use of such structures - which sever voting from cash flow rights - in the view of commentators, creates significant incentives for self dealing transactions. (See, e.g., Black, 2000; Bebchuk, Kraakman & Triantis, 2000) It has occasionally been suggested that the interests of public shareholders would be enhanced if dual-class share structures were subject to a "sunset clause" requiring a general shareholder vote on renewal of dual-class structure either upon the occurrence

[36] Under Canadian securities law, a person or company holding at least 20% of the outstanding voting or equity shares of a corporation is deemed, absent evidence to the contrary, to have sufficient holdings to affect materially the control of the issuer (see, e.g., *Securities Act* (Ontario), s. 1(1), definition of "distribution", para. (c)) and is referred to as a "control person" (see, e.g., NI 45-106, s. 1.1) or "control block person" for various securities law purposes.
[37] See, e.g., *Securities Act* (Ontario), s. 1(1), definition of "insider", para. (c).
[38] Tara Gray, *Canadian Response to U.S. Sarbanes-Oxley Act of 2002: New Directions for Corporate Governance,* PRB 05-37E, Parliamentary Information and Research Services, Library of Parliament, Ottawa, 4 October 2005 at 6. Available online, http://www.parl.gc.ca/information/library/PRBpubs/prb0537-e.htm.
[39] Tara Gray, "Dual-Class Share Structures and Best Practices in Corporate Governance" Parliamentary Information and Research Service, PRB 05-26E (18 August 2005) at p. 4.

of certain triggering events (such as the retirement of the CEO) or at certain specified time intervals (such as every 10 years).[40] Thus far, regulators have not seen fit to impose these or other requirements, although the there are certain disclosure requirements related to "restricted shares" imposed by OSC Rule 56-501; certain listing requirements prescribed in the TSX Company Manual applicable to "restricted securities" listed on the TSX[41]; and similar requirements applicable to restricted shares listed on the TSX Venture Exchange set out in a TSX Venture Exchange Policy.[42] It has also been argued that, in the event of a takeover bid for a corporation with a dual-class voting structure, all shares should be treated alike.[43] While there is no legislative requirement to this effect, the TSX restricted securities listing rules, and the TSX Venture Exchange restricted shares policy do include coattail requirements. The stated purpose of the TSX requirements are "to ensure that the fact that Common Securities are not of the same class as Restricted Securities will not prevent the holders of Restricted Securities from participating in take-over bid on an equal footing with the holders of Common Securities."[44] Language to similar effect appears in the TSX Venture Exchange Restricted Shares policy.[45] However, the issue of the extent to which controlling shareholders - whether that control is exercised through dual class shares or otherwise - should or should not be permitted to extract a premium on a sale of those shares which is not generally available to shareholders is a complex one, worthy of a lengthy study of its own.

Canadian law would appear to provide relatively strong protection for minority shareholder interests (although it has been suggested that uneven enforcement of certain laws - notably insider trading prohibitions - may partially undermine the practical benefits of such protections.)[46] The fact that Canada's existing minority shareholder protections have not apparently led to a widespread separation of ownership and control could be explained in a number of possible ways, including these:

- existing minority shareholder protections in Canada, though strong, are nevertheless inadequate; there are advantages to the existing pattern of share ownership which outweigh its disadvantages; and/or strong shareholder protections are not a sufficient cause for the separation of ownership and control.

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[40] See, e.g., Burgundy Asset Management Limited, "Second Class Owners?" Available online at <http://www.burgundy-asset.com/sept-96.asp>.
[41] See TSX Company Manual, s. 624.
[42] See TSX Venture Exchange Policy 3.5.
[43] *Ibid.*
[44] *Supra,* footnote 41, s. 624(l).
[45] *Supra,* footnote 42, s. 6.6.
[46] The Crawford Panel Report alluded to Canada's uneven enforcement record, commenting, "Currently Canada's reputation abroad suffers from a perception, which is probably justified, that our enforcement record is weak." *Blueprint for a Canadian Securities Commission, supra,* footnote 8, at 12.

On the latter point, Coffee has suggested that the separation of ownership and control may, in fact, have *preceded* the development of minority shareholder protections (at least in the United States) (Coffee, 2001). That separation may have come about earlier in the U.S. than, for example, in the United Kingdom owing to several factors including:

- high listing standards of the New York Stock Exchange, including an unwillingness to list the volatile securities of companies in such industries as mining (a sector that is especially important to Canadian exchanges);
- the important role of large investment banks whose reputational capital stood behind public offerings, and whose representatives sat on the boards of U.S. companies effectively deterring stealth acquisitions of control; and
- vigorous enforcement of anti-cartel rules that created powerful incentives for horizontal mergers.

Intriguingly, Coffee's thesis is that, historically, the United States had strong incentives to signal to prospective investors that their interests would be protected because of the early dependence of the American economy on foreign investment (Coffee, 2001), a topic of considerable interest for the Canadian economy too.

Critically, however, Coffee has suggested that dispersed share ownership arose in those jurisdictions where government intervened less in the market, allowing room for the private sector (including self-regulatory organizations) to emerge that were flexible and entrepreneurial and so were able to respond quickly with superior "regulatory" solutions. (Coffee, 2001)

A Task Force Member has noted that there is a strong incentive today for Canadian markets to be regarded as safe by prospective investors, perhaps in particular by foreign investors. One innovative method that has been suggested for enhancing the credibility of Canada's markets is a system of insurance against securities losses flowing from misinformation. The Task Force has commissioned a paper on this topic by Professor Tom Baker,[47]and a Task Force Member has raised the issue of whether or not such insurance would be interpreted by prospective investors as a signal of Canadian market strength, or a signal of Canadian market weakness. Professor Baker has suggested that it is more likely that the existence of insurance would be regarded as a signal of strength rather than of weakness.[48] I agree.

[47] Tom Baker, "Insurance Against Misinformation in the Securities Market" (June 5, 2006)
[48] *Ibid.,* at 20.

However, there are many more aspects of such a hypothetical insurance scheme that would need to be very carefully considered, and are well beyond the scope of this paper.[49]

A careful review of Canada's markets, including the historical development of those markets, in light of these sorts of considerations might well prove fruitful and enlightening, but for the balance of this paper the features of Canada's capital markets, as surveyed in this part, will simply be taken as given.

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[49] The introduction of insurance can often have unintended or hidden effects. For example, it has been noted that although bank deposit insurance is usually thought to have been introduced to protect depositors and to curb systemic risk (by preventing panic runs), it is evident that federal deposit insurance was originally introduced in Canada in 1967 (over the objection of the large banks) in order to protect the interests of trust and loan companies. See, e.g., Nicholls, 1998. As an aside, it is sometimes suggested that one potential advantage to government of creating a deposit-insurance programme with well-publicized limits, is that it may actually have the effect of limiting the practical exposure of governments to demands by depositors for compensation in the event of a firm failure. By contrast, introducing insurance for losses in capital markets (other than losses due to the insolvency of a financial firm) might have the unintended effect of changing the expectations of investors with respect to the role of government in the case of securities market losses. However, this complex subject will not be exposed further here.

5. Canadian Response to U.S. Regulation: the Sarbanes-Oxley Example

i. Introduction

Canadian regulators and legislators have, throughout much of the 20th century, looked to American federal and state initiatives when determining how to craft or revise Canadian securities regulation. One of Canada's earliest provincial securities statutes, the Manitoba *Sale of Shares Act*[50], was largely modeled on the Kansas "blue-sky" statute enacted the previous year. Since then, Canadian regulators have regularly considered American models when undertaking securities (and indeed corporate) regulatory reform. The influence of American securities laws is, on the one hand, understandable given the geographic proximity of the United States, the integration of the Canadian and U.S. economies, and the basic similarities between the U.S. and Canadian social, political, and economic systems. However, to the extent that characteristics of U.S. capital markets fundamentally differ from those of Canada, regulators and legislators must be cautious to ensure that well-intended efforts to ensure that Canadian markets are regarded as efficient and credible by world standards in the eyes of U.S. and other investors do not have unintended adverse consequences. The recent Canadian regulatory initiatives in response to the U.S. *Sarbanes-Oxley Act of 2002* offer a current example of some of the benefits - and potential pitfalls - of using U.S. capital market regulation as the basis for Canadian regulatory reform.

ii. Sarbanes-Oxley Act of 2002

The U.S. Congress enacted the *Sarbanes-Oxley Act of 2002* ("SOX") in July 2002, and signed by President George W. Bush on July 30 of that year. The Act was passed in some haste principally in response to a perceived "crisis" in corporate governance prompted by a series of corporate scandals at a handful of very large public corporations, including, in particular, Enron and WorldCom, both of which fell into bankruptcy within a period of 6 months. Defenders of the legislation have also pointed to longer-brewing general concerns about the reliability of financial information disclosed by public companies.

a) SOX Corporate Governance Reforms

Some of the most significant reforms introduced by SOX dealt with regulation of the accounting profession and other market-related matters that do not directly deal with corporations' internal

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[50] S.M. 1912, c. 75.

governance practices.[51] SOX also dealt with several issues that will have important consequential effects on corporate governance, but which nonetheless did not involve the specific mandatory governance practices and procedures[52] that are of principal interest here. These relate, for example, to existing differences between Canadian and U.S. rules regarding insider trading and mandatory timely disclosure of material changes. Accordingly, the corporate governance reforms introduced by SOX that are of principal interest here are the following:

- *Audit Committee Requirements:* Every member of the audit committee of the board of directors of each listed issuer must be independent.[53] (SOX did not, itself, further address the question of director independence; however, the rules of the NYSE and Nasdaq both require that a majority of a listed company's directors be independent, except in the case of companies that have a controlling shareholder or shareholders.) Moreover, each issuer must disclose whether or not at least one member of its audit committee is a "financial expert" and, if not, why not.[54] The audit committee must be responsible "for the appointment compensation and oversight" of the firm's auditors.[55]

- *CEO/CFO Certification of Financial Statements:* The CEO and CFO of each reporting company must personally certify annual and quarterly reports as to their accuracy and must, as well, certify the adequacy of disclosure controls and procedures.[56]

- *Repayment of Bonuses in the case of Restatements:* If an issuer is required to file an accounting restatement in certain cases, the CEO and CFO must reimburse the issuer for any bonus-based compensation received within the previous 12 months as well as for profits realized from sale of

[51] The Act included, for example, important provisions dealing with the establishment of the Public Company Accounting Oversight Board, Auditor Independence, financial analysts conflict of interest, resources for the Securities and Exchange Commission, mandating a series of studies on such topics as credit rating agencies, enforcement actions, investment banks, off-balance sheet transactions and special purpose entities and the consolidation of public accounting firms, mandating the SEC to create up-the-ladder reporting rules for attorneys, and increased penalties for certain "white-collar" offences.
[52] SOX included provisions, for example, dealing with insider trades during blackout periods and mandated enhancement of continuous disclosure obligations.
[53] SOX, s. 301.
[54] SOX, s. 407.
[55] SOX, s. 301.
[56] SOX, s. 302. The term "disclosure controls and procedures" was not used in SOX itself, but was the term used by the SEC to distinguish between the controls referred to in s. 302(a)(4) and the "internal controls" referenced in s. 404. See SEC Release Nos. 33-8124, 34-46427, IC-25722; File No. S7-21-02, and Exchange Act Rules 13a-14 and 15d-14.

the corporation's securities within that period.[57]

- *Prohibition of Personal Loans to Executives:* Issuers are not permitted to extend personal loans to directors or executive officers.[58]

- *Certification of Internal Controls:* Under s. 404 of SOX, the SEC is mandated to prescribe rules requiring each company's (other than investment company's) annual report to contain an internal control report, and requiring that the firm's auditors "attest to, and report on, the assessment made by the management of the issuer." The implementation of the s. 404 requirements has proved especially challenging for reasons that are discussed further below.

- *Disclosure regarding Code of Ethics:* Each issuer must disclose whether or not it has adopted a code of ethics for its senior financial officers and, if not, why not.[59] Although SOX itself referred only to senior *financial* officers, in its implementing rule, the SEC extended this provision to include an issuer's principal executive officer as well.[60]

- *Auditor Independence:* SOX prohibits auditing firms from providing certain non-audit services to their audit clients, and requires that other non-audit services may only be provided if pre-approved by the issuer's audit committee (subject to limited exceptions).[61]

b) Supposed Costs of Implementing SOX

> "The Sarbanes-Oxley Act has created significant problems for foreign investors with its regulatory structure…I am nevertheless acutely aware and disturbed by the fact that initial public offerings have moved away from the U.S. - and to a large extent have moved to London."
>
> - Alan Greenspan (former Federal Reserve Chairman), April, 2006[62]

The costs of implementing and complying with SOX have been the subject of considerable debate within the United States. The regulators, not surprisingly, have insisted that the benefits of the statute more than

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[57] SOX, s. 304.
[58] SOX, s. 402.
[59] SOX, s. 406.
[60] See SEC Release Nos. 33-8177; 34-47235; File No. S7-40-02.
[61] SOX, s. 201, 202.
[62] To be fair, Mr. Greenspan also stated that "the base of Sarbanes-Oxley is a definite advance in corporate governance in the US."

offset its costs. While many commentators are broadly supportive of the ends and means of SOX, some issuers and commentators do not share this sanguine view. Apart from Professor Romano's withering denunciation of SOX as "quack corporate governance" (Romano, 2005), perhaps the strongest indictment of the legislation is found in Ivy Ziying Zhang's study, "Economic Consequences of the Sarbanes-Oxley Act of 2002" in which the author argues that "the private costs of major provisions of SOX exceed their potential benefits". In fact, the author purports to find that loss in market value of U.S. companies accompanying major Sarbanes-Oxley related "events" in July 2002 was a staggering $1.4 trillion, although, to be sure, he concedes that not all of this loss in value could be directly blamed on the implementation of SOX itself. Nonetheless, he does estimate the total direct compliance costs at $260 billion, and argues that the indirect costs must be considerably higher. If the indirect costs were three times the direct costs, he notes, the total cost of SOX would be $1 trillion. (at 27). The same study also attempted to test empirically the relationship between strengthening corporate governance and firm value. The conclusion (no doubt disappointing, or perhaps irritating, for regulators) was that "the requirement to tighten corporate governance is generally value decreasing for firms." (at 37). The author does not deal (as he concedes) with the potential social benefits (as opposed to private costs and benefits) of SOX. Ivy Ziying Zhang's study attracted considerable attention internationally, not least because of the prominent mention made of the paper by the influential British periodical, *The Economist.*[63]

The choir of SOX naysayers enthusiastically applauded this anti-SOX sermon. Needless to say, the actual cost of SOX - and for that matter the actual benefits - will only be revealed through the passage of time. In the meantime, periodic alarm bells have been sounded (by more measured critics than Ivy Ziying Zhang) suggesting that U.S. regulators may have gone too far. Former Federal Reserve Chairman Alan Greenspan, though largely supportive of the governance improvements introduced by SOX, recently made the cautionary statement appearing at the beginning of this section, expressing his concern that London's lightly-regulated Alternative Investment Market (AIM) may have been a principal beneficiary of SOX. Comments to similar effect have also appeared in a recent *Report on Business* story concerning AIM.[64]

Nor is the collateral damage of SOX limited to a loss by U.S. exchanges of international issuers. It has

[63] "A Price Worth Paying?: Special Report Auditing Sarbanes-Oxley" *The Economist* (21 May 2005) at 71.
[64] "One of AIM"s luckiest breaks, however, has been the introduction of the Sarbanes-Oxley Act in the United States, a piece of legislation whose reporting and corporate governance requirements have made it very costly—some, like [Canadian entrepreneur Terry Matthews], would say prohibitive—for a small-cap company to go public in the U.S. markets." Sinclair Stewart, "Taking AIM at World's Small Caps" *Globe and Mail* (18 April 2006) at B10.

also been argued that existing U.S. public companies - facing onerous regulatory burdens - are being compelled in increasing numbers to go private. The Final Report of the Advisory Committee on Smaller Public Companies, a committee chartered by the SEC in 2005, noted that "domestic issuers who are going dark or private could pose significant competitive risks to U.S. companies and markets."[65] They went on to recommend that the fact that many companies had, or were considering, going private was a development that "should be carefully monitored."[66] Interestingly, the Advisory Committee's Report also included a recommendation to "make it easier for micro-cap companies to exit the Exchange Act reporting system",[67] a recommendation advanced in view of the Committee's recognition that "For investors in such companies, the burdens of public company status may far outweigh the benefits." [68]

The Advisory Committee was not the first to suggest that the requirements of SOX are contributing to the decision of a number of American public corporations to go private, (Morgenstern & Nealis, 2004; Skouvakis, 2004), although the empirical evidence in support of an increased rate of going private transactions is disputed. Clearly, whether or not the number of public companies opting to go private is or is not on the rise is an empirical question, and it would be reckless to place undue emphasis on this point without first determining whether, in fact, there has been an increase in the number of public companies going private in response to SOX. For the purposes of this paper, the principal point of interest is that very serious concerns have been raised in the United States about the possibility that overly intrusive regulation might overtax U.S. public companies, companies that are, as the data above shows, on average, much larger in size than Canadian companies and so putatively better able to shoulder heavy regulatory obligations than many - perhaps most - Canadian issuers. In particular, the gravest concerns have been voiced over the potential costs (especially for smaller issuers) of the internal control certification requirements provided for by SOX s. 404, an issue that is taken up further below.

iii. Canadian Response to *Sarbanes-Oxley*

a) Overview

No major financial reporting scandals had been reported in Canada during precisely the same period as

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[65] *Supra,* footnote 24, at 24.
[66] *Ibid.,* at 41.
[67] *Ibid.,* Recommendation IV.S.6, at 91.
[68] *Ibid.,* at 91. It is interesting to note a wording change made to this sentence from the earlier Exposure Draft. In the Exposure Draft, the words "investors in" did not appear, so that the statement spoke to the burdens suffered by the companies themselves, rather than by their investors.

the Enron and Worldcom revelations in the United States. However, certainly widely publicized financial scandals have occurred in Canada before, and since, the American debacles, including those involving Livent, Cinar Corporation, and, in particular, Nortel Networks which announced its intention to restate its financial results for the years 2000, 2001, and 2002. Nevertheless, it seems highly improbable that Canadian regulators would have independently launched the series of Canadian reforms that have been introduced following SOX. In other words, recent Canadian corporate governance regulation was not designed as a response to a problem but rather, a response to a "solution."

Many Canadian regulators and legislators in the fall of 2002 publicly expressed concern about the need for a Canadian response to SOX that would signal to capital market participants that Canadian market regulation was just as strong and protective of investors' interests as American regulation. There was, however, considerable disagreement amongst regulators and commentators as to the extent to which Canadian reforms ought to mirror the provisions of SOX itself and the SEC Rules and U.S. stock exchange listing requirements through which certain provisions of SOX had been, or would be, implemented. Broadly speaking, then-Ontario Securities Commission Chair David Brown initially favoured adopting rules substantially similar to SOX. Among those advocating a contrary position (citing, among other things, the sorts of material differences between Canadian and U.S. capital markets discussed in this paper) were British Columbia Securities Commission Chair Doug Hyndman and then-Toronto Stock Exchange CEO Barbara Stymiest.[69]

In the United States, the SOX reforms were embodied in federal legislation, rules promulgated by the SEC and listing requirements adopted by the national exchanges. In Canada, where there is no federal securities regulator, the regulatory response to SOX did not come in the form of federal legislation, but rather in the form of provincial securities law initiatives. Among the principal challenges for Canadian securities regulators since the autumn of 2002 has been to determine how to craft rules that will be perceived to enhance the credibility of Canada's capital markets, without proving so onerous that smaller companies find them disproportionately, and prohibitively, expensive.

To be sure, the challenge of tailoring regulation so as to accommodate the practical limitations faced by smaller companies is not unique to Canada. As shown in Section 2, a large number of U.S. public companies are also small-cap or micro-cap issuers. Cognizant of the special concerns of smaller issuers, in March of 2005, the U.S. Securities and Exchange Commission chartered a committee, the Advisory

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[69] For a review of the competing positions, see Christopher C. Nicholls, *The Canadian Response to Sarbanes-Oxley* (CMI Policy Comment, January 2003).

Committee on Smaller Public Companies (the "Advisory Committee"), to consider the concerns of such companies following the passage of SOX in the U.S. context, and that committee's final report is referred to from time to time throughout this paper.[70] But in Canada, the concerns of small issuers are especially acute because they constitute a much greater proportion of all Canadian public companies and because - in absolute terms - they are, on average, much smaller than companies regarded in the U.S. as small-cap or even micro-cap issuers.

Throughout the period of consultation and discussion that preceded the promulgation of Canadian rules in response to SOX, frequent references were made to the perceived need to adopt "proportional" or "scaled" regulation that would be sensitive to the needs of smaller Canadian issuers and to the fact that a significant number of Canadian public companies had major or controlling shareholders. Following a lengthy incubation period, Canadian regulators promulgated the following instruments in response to SOX reforms:

- National Instrument 52-108 *Auditor Oversight*
- Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings*
- Multilateral Instrument 52-110 *Audit Committees*
- Proposed Multilateral Instrument 52-111 *Reporting on Internal Control over Financial Reporting* (In March 2006, the Canadian Securities Administrators published a notice indicating that they had determined *not* to proceed with this instrument)[71]
- National Instrument 58-101 *Disclosure of Corporate Governance Practices*
- National Policy 58-201 *Corporate Governance Guidelines*

b) Bill 198 and Criminal Code Amendments

There were additional important reforms made to Ontario Securities legislation by the enactment of Bill 198.[72] The most dramatic feature of Bill 198 was the introduction of statutory civil liability for misrepresentations in continuous disclosure, a proposal that had pre-dated the SOX reforms by a number

[70] See Final Report of the Advisory Committee on Smaller Public Companies (April 23, 2006). An earlier exposure draft had been circulated for comment. See SEC Release Nos. 33-8666; 34-53385, *Exposure Draft of Final Report of Advisory Committee on Smaller Public Companies.*
[71] See (2006) 29 OSCB 2011.
[72] S.O. 2004, c. 31, Sched. 34.

of years.[73] The Ontario Securities Commission was also granted significantly enhanced rule-making powers, but the purpose of those additional powers was principally to facilitate the promulgation of new SOX-related corporate governance rules. The Canadian federal government also enacted significant reforms to the Criminal Code linked to financial crime of the sort associated with the U.S. scandals.[74] However most of the features of that statute (dealing with penalties for insider trading and fraud) are not amenable to variation in light of any particular features of Canada's capital markets. The Act does provide whistleblower protection, but for the most part it does not deal with the matters that are the principal focus of this paper, and so no more will be said about the bill here.

c) Cost-Benefit Analysis

Canadian regulators were eager to assure Canadians of the value of their reforms. Accordingly, they released a "cost-benefit analysis" confidently predicting that the benefits of the "investor confidence initiatives" were sure to exceed - materially - the expected costs.[75] Of the significant benefits to be gained, the regulators seemed especially convinced, asserting that "the probable benefits realized should be substantially greater than the numbers presented here." In fact, they proudly declared that benefits to be realized by their governance proposals would be "in the range of $1.0-10.1 billion," and likely toward the top end of that scale, whereas the cost estimates were only in the range of $163-$308 million. (Regulators can, of course, be forgiven for their understandably human desire to convince themselves of the uncompromising value of their work. Although with such huge financial benefits to be generated simply through the drafting of a few additional regulations, is it too cynical to ask why the securities regulators did not choose to switch on this apparent money machine even earlier?)

d) A Detailed Look at the Canadian SOX-Related Instruments

National Instrument 52-108 Auditor Oversight

National Instrument 52-108 requires all auditing firms that audit the financial statements of reporting issuers to have entered into a participation agreement with the Canadian Public Accountability Board "CPAB". It is beyond the scope of this paper to detail the role of each of the various bodies that exists in

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[73] In 1997, the Allen Committee recommended the creation of a regime of statutory civil liability for misrepresentations in the continuous disclosure of reporting issuers. See TSE Committee on Corporate Disclosure, Final Report, *Responsible Corporate Disclosure: A Search for Balance* (March 1997).
[74] Bill C-13, *An Act to Amend the Criminal Code(capital markets fraud and evidence gathering)*
[75] *Investor Confidence Initiatives: A Cost-Benefit Analysis* (2003), 26 OSCB 5010.

Canada to provide oversight of the Canadian accounting profession and Canadian auditing standards, beyond noting that such organizations include the Auditing and Assurance Standards Oversight Council (which oversees the activities of the Assurance Standards Board), the Accounting Standards Oversight Council (which oversees the activities of the Accounting Standards Board and the Public Sector Accounting Board), as well as the CPAB itself.

The OSC, in its cost-benefit analysis, explained that the benefits of NI 52-108 are that it "will improve investors' confidence in our market and, as a result, help reduce the cost of capital for reporting issuers."[76]

British Columbia elected not to adopt Multilateral Instrument 52-108. B.C. regulators did not take issue with the notion of having auditors of public companies subject to the oversight of the Canadian Public Accountability Board. However, they regarded the proposed instrument as containing "more detail than is necessary, particularly in the requirements imposed on auditors and the definition of good standing."[77]

Multilateral Instrument 52-109 Certification of Disclosure in Issuers' Annual and Interim Filings

Multilateral Instrument 52-109 was adopted in all Canadian jurisdictions except British Columbia. The certification requirements in the certificate are equivalent to the SOX rules requiring certification by the Chief Executive Officer and Chief Financial Officer of each reporting issuer as to the accuracy of filings and the adequacy of disclosure controls and procedures. MI 52-109 applies to all Canadian reporting issuers, although there are exemptions for issuers that are in compliance with s. 302(a) of SOX.

In its cost-benefit analysis document,[78] the OSC acknowledged that "smaller firms will face larger proportionate costs than large firms" in complying with the CEO/CFO certification requirements. The basis for this increased cost, in the OSC's view, relates to the need of senior executives of such companies to obtain the assistance of outside advisors. This additional potential cost is mitigated, in the OSC's view, by the fact that smaller organizations are less likely to require significant additional expenditures on internal controls. It is somewhat ironic, however, that the regulators did not regard the increased time demands on companies as representing a significant cost factor given that they acknowledge that their interview findings were "based on a relatively small sample primarily due to a low response rate on

[76] *Ibid.,* at 5016.
[77] BCN 2003/25-"Investor Confidence Rules-The BCSC Approach" (21 June 2003).
[78] *Supra,* footnote 75.

inquiries. *Many of those contacted were unwilling or unable to participate in the survey because they did not have sufficient time to evaluate SOX or the Proposed Instruments in Canada.*"[79]

The other ongoing challenge of proportional regulation is that, while additional regulatory requirements are disproportionately burdensome for smaller issuers, yet "erroneous financial reporting is especially prevalent among smaller firms…"[80] However, the regulators also assert that the "benefits of reduced financial misstatements are proportionately larger for smaller firms since the size of misstatements are generally proportionately larger."[81]

In March, 2006, in a release[82] announcing that the CSA was not going to proceed with Multilateral Instrument 52-111 relating to officer certification and auditor attestation of internal controls (discussed below), the CSA also announced a proposed revision to MI 52-109. Under the expanded MI 52-109, all reporting issuers other than investment funds would be required to certify the effectiveness of the issuer's internal controls in their annual certificates, although there would not be a requirement (as MI 52-111 had originally proposed) that the issuer obtain an auditor's internal control audit opinion. The proposed changes would, in any event, only apply in respect of fiscal years ending on or after December 31, 2007 at the earliest. (It should be noted, though, that the requirement that CEOs and CFOs certify that they have designed internal controls and caused changes in internal controls to be disclosed will take effect earlier, namely with fiscal years ending on or after June 30, 2006. It is only the certification with respect to the *evaluation of the effectiveness* of these controls that is to be delayed.) The March notice specifically stated the regulators did "not propose to distinguish between non-venture issuers and venture issuers, with the result that issuers will have to comply with the additional internal control reporting requirements regardless of where their securities may be listed or quoted. This proposal recognizes that internal control over financial reporting is important for all reporting issuers, regardless of their size or listing."[83]

The B.C. Securities Commission's disagreement with Multilateral Instrument 52-109 stemmed from a belief that the certification requirements were unnecessary in view of the legal duties relating to disclosure to which officers and directors of public companies were already subject. Accordingly, from the perspective of the BC Securities Commission, nothing worthwhile would be accomplished by

[79] *Ibid.,* at 5013. [Emphasis added.]
[80] *Ibid.*, at 5013.
[81] *Ibid.*, at 5013.
[82] CSA Notice 52-313-Status of Proposed MI 52-111 *Reporting on Internal Control Over Financial Reporting* and Proposed Amended and Restated Multilateral Instrument 52-109 *Certification of Disclosure in Issuers' Annual and Interim Filings* (2006), 29 OSCB 2011.
[83] *Ibid.*, at 2012.

adopting these new certification rules and yet there were possible disadvantages to doing so. For example, they noted, directors might attempt to abdicate their responsibility for accurate financial reporting by claiming to have relied on certifying officers.[84]

The B.C. Securities Commission's objection to MI 52-109 was not expressly linked to any particular concerns the instrument might raise for smaller issuers. However, given the importance of smaller public issuers within the B.C. securities market, there is little doubt that the views of the B.C. Commission reflected especial sensitivity to the perceived needs of those smaller issuers.

Multilateral Instrument 52-110 Audit Committees

Multilateral Instrument 52-110 offers, perhaps, the clearest example of a "made in Canada" response to a SOX requirement. MI 52-110 modifies the U.S. approach to audit committees in an effort to accommodate perceived distinct features of Canada's capital markets. Notwithstanding this attempted flexibility, however, the instrument was not adopted in British Columbia.

It will be recalled that SOX envisioned a more enhanced and formalized role for audit committees, mandating the independence of audit committee members, and instituting a "comply or explain" regime aimed at encouraging firms to ensure that at least one member of the committee has financial expertise.[85]

Multilateral Instrument 52-110 requires all reporting issuers to have an audit committee (2.1), and stipulates that the firm's external auditor must report directly to the audit committee (2.2). The audit committee is required to be directly responsible for overseeing the external auditor's work (2.3(3)). The instrument does not include a requirement that a member of an audit committee be a "financial expert"; however, it does, with limited exceptions, stipulate that each member must be "financially literate." (3.1(4)), a term defined in s. 1.6 of the instrument.

Generally, each member of the audit committee must be "independent."(3.1(3)). The meaning of independence for this purpose is broad, and is cast in terms of "no direct or indirect material relationship"

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[84] BCN 2003/25. (This notice subsequently lapsed and, accordingly was repealed in 2004.)

[85] Of course, in the case of public companies listed on major U.S. exchanges, there are additional audit committee requirements. For example, s.303A of the NYSE Listed Company Manual includes audit committee rules, including a requirement that all members of the committee be financially literate.

with the issuer. It is a definition drawn, as the accompanying policy 52-110 CP acknowledges, from both the SEC's and the NYSE's comparable rules.[86]

Rigorous board (or board committee) independence requirements were thought to pose special problems in the Canadian context for at least two reasons. First, in the case of the smallest Canadian public companies, attracting and retaining qualified board members - even before the introduction of these new requirements - was said to pose a significant challenge. With neither significant compensation nor significant prestige to attract outsiders to diminutive public company boards, the possibility that the pool of eligible small public company directors might be further attenuated was the subject of some debate in the weeks and months following the implementation of SOX in the United States.

There are two exceptions to the independence requirement, and these exceptions are of particular relevance in the case of those public companies that have a controlling shareholder. First, an audit committee member is exempt from the independence requirement if the member is also a director of an affiliated company, provided that he or she is otherwise independent of the issuer and that affiliated company. Thus, for example, an independent member of the board of a parent company is permitted to sit on the audit committee of a subsidiary company. There is a second, broader exemption from the independence rules that applies in the case of subsidiaries and affiliates. This broader exemption allows a director whose affiliation with an issuer is the only bar to his or her being considered an independent member of the issuer's board to serve on the issuer's audit committee, provided certain conditions are satisfied. These conditions stipulate that such a person cannot be an executive officer, or an immediate family member of an executive officer, of the affiliate; cannot act as chair of the issuer's audit committee; and must, in the view of the issuer's board of directors, be a person who is able to exercise impartial judgment and whose appointment is "required by the best interests of the issuer and its shareholders."

This latter exemption, intended to accommodate the desire of controlling shareholders to enjoy audit committee representation, echoes an approach to dealing with the "independence" of directors of public companies with controlling shareholders developed in the influential Dey Report on Corporate Governance in 1994.[87] In the Dey Committee's interim report, the committee had proposed that controlling shareholders of a public company could not be considered unrelated (independent) members of the company's board of directors. This proposal was strongly opposed by certain major shareholders of

[86] Companion Policy 52-110 CP, s. 3.2.
[87] Toronto Stock Exchange Committee on Corporate Governance, "Where Were the Directors?" (December 1994).

Canadian public companies, and so, in its final report, the Dey Committee relented. The final report stated that the committee had

> "received a number of persuasive comments on the Draft Report to the effect that treating such a director [i.e., a director who is a significant shareholder or related to a significant shareholder] would compromise the ability of the significant shareholder to exercise control and that the ability to control through the election to the board of individuals related to the significant shareholder is the right of the significant shareholder. It was also argued that investors acquire shares in corporations with a significant shareholder generally aware of the shareholding, and relying in many cases on the significant shareholder to exercise control and execute his or her strategy for the corporation."[88]

There is also a key exemption in MI 52-110 from the requirements relating to the composition of the audit committee for venture issuers. A "venture issuer" is defined in s. 1.1 of the instrument as an issuer that "does not have any of its securities listed or quoted on the Toronto Stock Exchange, a U.S. marketplace or a marketplace outside of Canada and the United States of America." Thus, most Canadian companies listed on the TSX Venture Exchange and CNQ (other than those that are listed on a U.S. marketplace) would be considered venture issuers. This designation was presumably intended to function as a proxy for smaller issuers, although it is a rough proxy since, based on data from Dec. 2005, a significant number of TSX Venture Exchange issuers have market capitalizations larger than those of many TSX listed companies. For example, of the 1500 largest companies in Canada by market capitalization, 232 are TSX Venture-listed companies. And, of the 1500 smallest listed public companies in Canada, 102 are TSX-listed companies.

Although venture issuers are exempt from the audit committee composition requirements, they are obliged to disclose the audit committee's charter, the names of each member of the audit committee, and whether or not each such member is independent and financially literate. [89] Thus a "comply or explain" approach is used for venture issuers in place of mandatory rules.

Also noteworthy, given the increasing importance of the income trust sector in Canada's capital markets, the audit committee rules are not limited to corporate entities. The accompanying policy, 52-110CP,

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[88] *Ibid*., at para. 5.12.
[89] See Form 52-110F2, s. 2.

makes clear that the requirements of the rule extend to non-corporate entities including, for example, income trusts. [90]

MI 52-100 does not strictly prohibit the provision of non-audit services by a firm's auditors. This concession, again, reflects Canadian capital market considerations. Some Canadian issuers - particularly smaller issuers - had expressed concern over any such blanket prohibition since the cost of retaining multiple advisors could prove prohibitive for the smallest firms. Instead of an outright prohibition on the provision of non-audit services, then, MI 52-110 requires that the audit committee must pre-approve all non-audit services provided by the firm's auditor. (2.3(4))

The OSC, in assessing the value of its audit committee proposals, focused in particular on the possibility (and probability) of earnings management by public firms. By comparing the volatility of cash flows to the volatility of earnings, the OSC inferred that there was "a significant and widespread practice of earnings smoothing."[91] Their research indicated that "an independent audit committee was found to have a very significant impact on the incidence of earnings smoothing."[92] However, splitting the roles of board Chair and CEO and, significantly, mandating that the auditor report directly to the audit committee "were not found to be significant." (Although they suggested this finding - undoubtedly disappointing given their proposals - "may be related to data problems.")

The British Columbia Securities Commission (BCSC) did not endorse (nor did it adopt) the Audit Committee rule, noting that the new draft B.C. Securities legislation (a statute which, it has recently been announced, the B.C. government does not intend to bring into force until at least December 31, 2007)[93] mandates that each public company have an audit committee. This general requirement, in the BCSC's view, coupled with directors' fiduciary obligations, offered sufficient protection. A codified "one-size-fits-all" approach to audit committee requirements, according to the BCSC, would not adequately take account of evolving corporate governance standards.

[90] Companion Policy 52-110CP, s. 1.2.
[91] *Supra,* footnote 75, at 5013.
[92] *Ibid.*, at 5013.
[93] See News Release, "Securities Laws to Be Harmonized Across Canada" (10 February 2006) Available online: http://www.bcsc.bc.ca/release.asp?id=2944.

Proposed Multilateral Instrument 52-111

The most controversial aspect of SOX was the s. 404 internal control certification requirement. The SEC more than once delayed the date by which U.S. reporting companies were required to comply with the internal control rules,[94] and, in particular, permitted lengthier implementation delays for smaller companies (non-accelerated filers.)

The subject of internal control reports proved a tremendous challenge for Canadian regulators as well. Former OSC Chair David Brown described the matter as "the most difficult issue I've seen in my time as chair."[95] Originally, the securities regulators in Canadian provinces and territories other than British Columbia had published for comment Proposed Multilateral Instrument 52-111, which, if passed, would have introduced requirements similar to those of SOX 404 for certification of internal controls and for an auditor's internal control audit opinion. However, on March 10, 2006, the Canadian Securities Administrators (CSA) issued a notice indicating that it was no longer proceeding with MI 52-111. At the same time, the CSA indicated that it was proposing amendments to MI 52-109 to include CEO and CFO certification of internal controls. Accordingly, one of the key consequences of the CSA's decision not to proceed with MI 52-111 was that there would not be a requirement for companies to obtain an auditor's internal control audit opinion.

Even before the CSA indicated that it would not proceed with MI 52-111, the B.C. Securities

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[94] Originally, accelerated filers were to begin complying for fiscal years ending after June 15, 2004, and non-accelerated filers for fiscal years beginning after April 15, 2005. These dates were first changed to November 15, 2004 and June 15, 2005, respectively. (Release No. 33-8392). Then, in November 2004, the SEC granted an exemption from the internal control reporting requirements for smaller accelerated filers (those with public equity float of less than $700 million) and with fiscal years ending between November 15, 2004, and February 28, 2005 (Release No. 50754). In March 2005, the SEC further extended compliance dates for non-accelerated filers by one year (viz. to begin for fiscal years ending after June 15, 2006) (Release no. 33-8545). The release announcing this extension noted that the delay "will afford smaller issuers that are subject to Exchange Act reporting time to consider the new guidance in the COSO Framework." In May 2005, the SEC issued a statement, "Implementation of Internal Control Reporting Requirements" in which, among other things, the Commission noted that "internal controls over financial reporting should reflect the nature and size of the company to which they relate. Particular attention should be paid to making sure that implementation of Section 404 is appropriately tailored to the operations of smaller companies." Then, yet again, in September 2005, the SEC announced a further one-year postponement of internal control reports for non-accelerated filers (that is, for fiscal years ending after July 15, 2007). In the same release, the SEC proposed a new category of large accelerated filers—namely those with a public float of $700 million or more. (See "SEC Votes to Propose Changes in Filing Deadlines and Accelerated Filer Definition; Postpone 404 Compliance Date for Nonaccelerated filers; Propose Issuing Section 28(e) Interpretive Guidance."

[95] David Brown, "The State of Corporate Governance in Canada" (Remarks delivered at McMaster University, March 10, 2005), available online at <http://www.osc.gov.on.ca/About/Speeches/sp_20050310_db-corp-gov-in-cdn.jsp>.

Commission had expressed significant reservations about the proposal. The BCSC regarded the internal control rule as likely to result in costs that exceeded its benefits. Indeed, the BCSC stated, "We have seen no credible evidence that any benefits arising from the Internal Control Rule would outweigh these potentially significant costs and adverse outcomes."[96]

Similar concerns about the costs to smaller companies of complying with the new internal control rules have also been raised in the United States. One of the chief observations of the Advisory Committee on Smaller Public Companies was that "Section 404 [the section of SOX dealing with internal controls] represents a clear problem for smaller public companies and their investors, one for which relief is urgently needed."[97] The problems of s. 404 compliance for smaller public companies had prompted the Committee of Sponsoring Organizations of the Treadway Commission (COSO) to issue an exposure draft for comment in October 2005 entitled, "Guidance for Smaller Public Companies Reporting on Internal Control Over Financial Reporting."

The U.S. experience with s. 404 also argues for wariness in assessing sanguine regulatory "cost-benefit" analyses. As the Advisory Committee noted, "Studies into the consequences of Section 404 indicate that actual average costs of Section 404 compliance have in fact been far in excess of what was originally anticipated." [98] Indeed, although it is acknowledged that first-year costs, in particular, will be high, the Advisory Committee cites a study by the Big Four accounting firms that suggest that "second-year total costs for public companies with a market capitalization between $75 million and $700 million will still equal, on average, approximately $900,000."[99] (The SEC's release adopting the s. 404 rule estimated that average annual costs over the first three years would be just $91,000.) [100](And the costs for smaller companies are particularly high.

In the U.S., it is estimated that 1/4-1/3 of the cost of implementing s. 404 is external audit fees.[101] So to the extent that the recent announcement by the CSA of the intention not to proceed with proposed MI 52-111, though welcome, will nevertheless likely mean that still between 2/3 and ¾ of the costs associated with compelling managers to certify internal controls will be borne by Canadian issuers—of all sizes. In the United States, justification for these costs is presumably based on the desire to (a) curb fraud or other

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[96] BCN 2005/08 BCSC Comments on Proposed Multilateral Instrument 52-111 (4 February 2005).
[97] *Supra,* footnote 24, at 25.
[98] *Ibid.,* at 32.
[99] *Ibid.,* at 33.
[100] *Ibid.,* at 29.
[101] *Ibid.,* at 34.

abuses of the sort associated with Enron, Worldcom etc.; and (b) generally improve the quality of financial disclosure of U.S. public companies, even where outright fraud is not an issue. There had been concerns raised in the United States, before the Enron debacle, about potential weaknesses in the quality of financial disclosure - a problem sometimes associated with the increasing frequency of financial restatements. Although there have certainly been several recent high-profile Canadian examples of such problems as well, it is not clear that a case had been made that the problem was endemic in Canada, and, given the active monitoring role large shareholders are able to play in many Canadian public companies, it is not clear that one would expect such problems to become as common as in the United States where widely dispersed share ownership of public companies is more common. (See Coffee, 2005)

National Instrument 58-101 Disclosure of Corporate Governance Practices

National Instrument 58-101 prescribes a series of disclosure rules with respect to issuers' corporate governance practices. NI 58-101 does not mandate the adoption of formal governance practices, but only requires reporting issuers to disclose the practices it has chosen to adopt. Of course, it is well understood that the purpose of such disclosure obligations is to persuade issuers to adopt those practices that they will be most comfortable to disclose to their investors. Yet, although NI 58-101 deals with disclosure obligations rather than substantive corporate governance rules, still the instrument distinguishes between two classes of issuers: venture issuers and other reporting issuers. This distinction, once again, is a nod towards scaled or proportionate regulation. The disclosure required of venture issuers (in form 58-101 F2) is slightly less detailed than the disclosure required of other issuers (in form 58-101F1), although in most essential respects the two forms are very similar.

National Policy 58-201 Corporate Governance Guidelines

National Policy 58-201 sets out a series of non-binding corporate governance guidelines for public companies. Part 1 of the Policy specifically adverts to the distinct characteristics of Canada's capital markets which Canada's securities regulators are said to have taken into account in formulating the NP 58-201 guidelines.

Prior to the enactment of this National Policy, the Toronto Stock Exchange Company Manual had included a set of corporate governance guidelines and related "comply or explain" disclosure obligations applicable to TSX-listed companies. These provisions have been repealed with the adoption of National Policy 58-201, and replaced with a statement that any listed issuer subject to National Instrument 58-101 must disclose its corporate governance practices in accordance therewith.[102] It should also be noted that the forerunner of National Policy 58-201, proposed Multilateral Instrument 58-201, was not originally going to be adopted in British Columbia or Quebec and the regulators of those provinces (as well as Alberta's regulator) proposed a parallel (though not identical) instrument, Multilateral Instrument 51-104. The ongoing tension between the two major western securities regulators and the Ontario Securities Commission, of which this debate over 58-201 is an illustration, reflects an underlying struggle between two legitimate but competing regulatory philosophies. One is informed by the desire to protect the perceived integrity of the regulation of Canada's largest issuers, and the other is influenced by the need to ensure flexibility for, and avoid placing undue regulatory burdens upon, Canada's smallest issuers.

iv. Lessons from the Canadian Response to Sarbanes-Oxley?

a) Two Solitudes

Canadian securities regulation (with apologies to novelist Hugh MacLennan) embraces "two solitudes". The desire to facilitate the growth and competitiveness of Canada's largest companies motivates regulators, especially in Ontario, along with some capital market participants, to support a regulatory regime that closely resembles the American model: centralized, rules-based, and highly regimented. On the other hand, the competing desire to make Canada's markets "issuer friendly", and flexible, in order to facilitate the operation of Canada's many small issuers and even potentially attract foreign issuers, leads other Canadian regulators (notably in British Columbia and Alberta) together with other capital market participants to support a regime that would emulate the success of more streamlined markets, such as London's Alternative Investment Market (AIM), a market characterized by a significant number of foreign issuers,[103] and apparently enjoying considerable "momentum."[104] The suggestion that regulation ought to be "scaled" or "proportional" (or "two tiered") in order to accommodate these twin regulatory concerns is neither radical nor unprincipled, and has, indeed, been adopted in other jurisdictions, including the United States.[105] Thus, it is relatively uncontroversial to state as a general proposition:

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[102] TSX Company Manual, s. 472.
[103] About 18% of all companies listed on the London Stock Exchange (both the Main Market and AIM) are non-UK companies. (See LSE company statistics, available online at <http://www.londonstockexchange.com/en-gb/pricesnews/statistics/listcompanies/>)
[104] *Supra,* footnote 24, at 41.
[105] *Ibid.,* at 20 ff.

<u>Recommendation #1:</u> Scaled or proportional securities regulation should be considered both appropriate and necessary in the Canadian securities regulatory context.

Nor is it only the great disparities in the size of Canadian public issuers that leads to conflicting regulatory objectives. It is also clear that the nature of protective regulation must vary depending on the shareholding patterns of public companies. In the case of public companies with widely dispersed shareholders, it is the manager/shareholder relationship that is the principal source of agency costs. However, in the case of public companies with a legal or de facto controlling shareholder the principal concern is that controlling shareholders will use their position to extract private benefits of control to the detriment of minority shareholders.

Although several of the Canadian securities regulatory initiatives promulgated in response to SOX did appear to recognize the need for proportional regulation (by differentiating between "venture issuers" and other reporting issuers in certain circumstances), basing distinctions on the issuer's choice of marketplace alone is not necessarily an optimal solution. As indicated earlier, a significant number of TSX Venture Exchange companies are actually larger than TSX-listed companies. One notes that the U.S. Advisory Committee on Smaller Public Companies has suggested defining a smaller public company in terms of six determinants:

- "The total market capitalization of the company*; [a measure preferred by the Committee over, for example, public float because of its simplicity and because, in the Committee's view, it reflects a more accurate measure of total risk to investors]*
- A measurement metric that facilitates scaling of regulation;
- A measurement metric that is self-calibrating;
- A standardized measurement and methodology for computing market capitalization;
- A date for determining total market capitalization; and
- Clear and firm transition rules, *i.e.,* small to large and large to small".[106]

A crucial element of this proposal is that the classification of companies (and accordingly the degree of regulatory burden to which they are subject) is not static, but is undertaken at periodic "recalculation dates". The committee refrained from recommending any specific frequency for such recalculation, but

[106] *Ibid.,* at 12, Recommendation II.P.1.

did note that too-frequent recalculation (and therefore re-categorization) "even on an annual basis" might lead to excessive uncertainty.[107]

The Canadian "venture issuer" classification offers the advantages of stability and certainty. However, the market capitalization method of categorization proposed by the Advisory Committee deserves careful consideration in Canada. Such an approach, despite its shortcomings, may well represent a method for distinguishing between larger and smaller public issuers that is more appropriate than the current blunt "venture issuer" non-venture issuer classification.

It has often been suggested that a principles-based approach to securities regulation offers measurable advantages over the traditional U.S.-style "rules-based" approach; and a call for more principles-based regulation has been made in connection with certain recent proposed securities law initiatives in Canada.[108] The potential advantages of principles-based regulation should not be discarded in the pursuit of enhancing confidence in the Canadian capital markets. Rather, flexible regulation may well help to distinguish Canadian markets from their U.S. counterparts in ways that prospective investors and issuers may well find attractive.

Recommendation #2: Canadian regulators should consider the extent to which Canadian laws could reflect a more flexible and less rules-based approach to corporate governance than in the U.S., at least with respect to smaller Canadian issuers.

b) The Risk of Regulatory Over-Reaching

American scholars are familiar with the story of how Delaware attained its dominant place within the U.S. corporate charter competition hierarchy. Canadians may be less familiar, though, with the fact that it was New Jersey, not Delaware that first actively sought out-of-state corporate charters, and indeed led Delaware in the corporate charter race until about 1913. It was in that year that then New Jersey Governor Woodrow Wilson brought in a series of tough antitrust measures that ended New Jersey's advantage as a

[107] *Ibid.,* at 17, note 42.
[108] The Crawford Panel Report, for example, has argued that "it is desirable to have as much principles-based regulation as is feasible…" *Blueprint for a Canadian Securities Commission*, *supra,* footnote 8, at 17. British Columbia's recently passed (though unproclaimed) *Securities Act* expressly embraced a principles-based model. Indeed, as a news release issued by the B.C. Securities Commission at the time of the launch of the new draft legislation put it, "Principles-based regulation is the backbone of the BC Model." See News Release, "Legislative model shows how streamlined and simplified securities regulation can work" (April 15, 2003), available online at http://www.bcsc.bc.ca/release.aspx?id=423.

corporate haven. As Kirk explains, "Wilson's leading biographer holds that [the anti-trust bills] showed Wilson's naiveté and willingness to accept easy solutions, along with his 'colossal ignorance of economics.'"[109]

It would be impertinent and misleading to suggest that SOX might prove as disastrous for America's capital markets as Wilson's anti-trust legislation proved for New Jersey's corporate tax coffers. Access to the enviably deep and liquid U.S. capital markets offers far too many advantages to corporations (and their investors) to be outweighed by a single legislative initiative, especially one as well-meaning as SOX. But features of Canada's markets suggest that they may well be more fragile. Accordingly, Canada's regulators do not have the luxury of crafting regulation secure in the knowledge that the lure of Canada's markets will ensure that modest regulatory burdens will not dampen the interest of issuers and investors. Rather, Canadian securities regulation may need to be crafted with much greater concern for its perceived impact on investors and issuing corporations, and with much more sensitivity to the international competition for listings of small-cap firms.

c) Beyond SOX-Related Reforms

Introduction

The recognition that the central features of Canadian capital markets ought, somehow, to be taken into account in the design and implementation of Canadian securities regulation does not definitively imply a specific design for the fashioning from whole cloth of regulatory instruments to address the sweeping range of issues that are conventionally considered to fall within the rubric of "securities regulation." As has been seen, Canadian regulators, in responding to SOX, were certainly cognizant of the fact that one-size-fits-all regulation would be inappropriate for Canada. The specific carve-outs in certain cases for "venture issuers" and for issuers with controlling shareholders are a tangible reflection of this regulatory sensitivity. Attentiveness to the distinctive features of Canada's markets, accordingly, demonstrably assists in the *analysis* of rules crafted elsewhere. But to what extent can such attentiveness undergird the *synthesis* of a regulatory framework that is something more than a studiously crafted reaction to rules and principles developed in (and for) other larger financial centres?

[109] William E. Kirk, III, "A Case Study in Legislative Opportunism: How Delaware Used the Federal-State System to Attain Corporate Pre-Eminence" (1984) 10 Journal of Corporation Law 233 at 257.

Three tentative areas of regulatory interest that might usefully be informed by careful consideration of Canadian market characteristics will be offered here: Insider Trading, Market Manipulation and Enforcement of Disclosure Rules; Related-Party and Going Private Transactions; and Public Offering and Private Placement Rules.

Insider Trading, Market Manipulation, and Enforcement of Disclosure Rules

To the extent that regulators wish to enhance the credibility of Canada's capital markets and investor confidence in those markets, clearly enforcement of Canada's existing insider trading and market manipulation laws is critical, and resources directed toward such enforcement might reap materially greater benefits than if those same resources were directed instead toward crafting further corporate governance proposals and monitoring disclosure related to those proposals. The shares of smaller public companies are especially vulnerable to price manipulation, and minority shareholders of corporations with controlling or other major shareholders may be subject to exploitation by insiders enjoying informational advantages. Accordingly, the two dominant characteristics of Canada's capital markets seem to argue strongly for increased enforcement in the areas of market manipulation and insider trading.

<u>**Recommendation #3:**</u> **Canadian regulatory resources could usefully be directed towards enforcement of Canada's existing market manipulation and insider trading laws.**

The traditional English and Canadian emphasis on "comply or explain" disclosure rules, rather than mandatory corporate governance rules should, in the absence of compelling arguments to the contrary, be the preferred means of regulation for Canadian firms. However, the efficacy of a "comply or explain" regime depends upon the accuracy of corporate disclosure. To the extent that strong mandatory regulation solves an adverse selection (or "lemons") problem,[110] especially among small issuers, such regulation should facilitate the critical function of financial markets to ensure that capital flows to the most highly-valued use. A rigidly enforced "comply or explain" regime could well achieve the same benefits as mandatory formal governance rules, with companies choosing for themselves that menu of governance options that optimally balances compliance costs against (perceived) shareholder benefits (and therefore, presumably, lower costs of capital). The challenge for regulators is to ensure that there are sufficient incentives to guarantee high levels of compliance with disclosure rules. Self-enforcing disclosure laws (depending upon the initiative of aggrieved investors, for example) have long been favoured by many

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[110] The "lemons" problem is associated with the work of economist George Akerlof. See G. Akerlof, "The Market for Lemons: Quality Uncertainty and the Market Mechanism" (1970), 84 Quarterly Journal of Economics 485.

Canadian corporate law reformers and commentators. However, relying on investor enforcement may well prove inadequate in a "comply or explain" disclosure-based regime because it may be difficult to link a "mere" failure to disclose compliance with a non-mandatory governance requirement decision with a definable and measurable investment loss in the case of a particular issuer. Accordingly, if there are inadequate incentives for the launching of private enforcement actions, to ensure the reliability of disclosure, securities regulators will need to assume a prominent enforcement role.

Related-Party and "Going Private" Transactions

Whatever the historical, economic or political reasons, the fact is that Canada's capital markets are today characterized by a significant number of corporations with controlling or otherwise significant shareholders. Accordingly, Canadian legislators and regulators must be (relatively) more concerned than their U.S. counterparts about the risk that controlling shareholders may seek to extract private benefits of control to the detriment of minority shareholders, rather than merely the risk that entrenched managers will engage in the "shirking or sharking" behaviour that is said to be the greater risk in the case of public corporations with widely dispersed shareholders. In practical terms, as Coffee and others have correctly noted, this may mean that in markets such as ours, a narrow regulatory focus upon deterring accounting fraud of the sort observed in Enron and Worldcom may be misplaced, and that regulatory resources would be better directed toward preventing unfair related party and going private transactions (Coffee, 2005).

Yet, as commentators have noted, it is not necessarily desirable to wholly preclude controlling shareholders entirely from extracting private benefits of control, since a legal regime that eliminated all such benefits would provide insufficient incentive for anyone to acquire a controlling position and thus would prevent one of the most effective means of curbing managerial power. (Gilson & Gordon, 2004) And, as the Dey Committee noted, many small investors choose to invest in public companies with controlling shareholders precisely because it is their expectation that those controlling shareholders will continue to effectively manage the corporation. [111]

Canadian SOX-related reforms did not address the particular issues that are raised by related-party transactions undertaken by affiliated companies or companies with a controlling shareholder. Regulatory interest in such transactions, however, has some history in Canada. The Ontario Securities Commission, in particular, has focused considerable attention upon such transactions. OSC Rule 61-501 is the key

[111] *Supra,* footnote 87.

regulatory instrument dealing with, among other things, two types of transactions that offer particular risk of exploitation of minority shareholders by controlling shareholders: related-party transactions and "business combinations" (a term that includes those transactions more commonly known as "going-private transactions"). OSC Rule 61-501 is the successor to former OSC Policy 9.1. Policy Statement 9.1, in turn, may be traced to an earlier policy - 3-37 - originally drafted to deal with special concerns arising in the context of issuer bids (or issuer self-tender offers.) As Daniels and MacIntosh (1991) note, however, "rules"[112] relating to related-party transactions were added when the policy was extensively revised in 1990, following a high-profile and controversial related-party transaction involving one of Canada's largest corporate empires.

The current version of OSC Rule 61-501 sets out a fairly detailed regulatory framework within which certain transactions may be undertaken and seeks to provide certain safeguards for minority shareholders, including valuation and "majority of the minority" approval requirements.

While the prevalence in Canada of public companies with controlling shareholders would appear to make regulatory scrutiny of such transactions entirely appropriate, it has been argued that Rule 61-501 may not provide optimal regulation of corporate transactions initiated by controlling shareholders for at least two reasons. First, by readily accommodating going-private transactions, Rule 61-501 may have had the effect of facilitating the expropriation of minority shareholders' interests in circumstances that would not otherwise have been sanctioned by corporate law compulsory acquisition rules. Typically, Canadian corporate law acquisition rules permit a takeover bidder who has acquired at least 90% of the outstanding shares of a corporation not already owned by the bidder to acquire the remaining shares of the corporation from those shareholders who did not tender to the bid, either by paying the bid price or "fair value."[113]

However, even when a bidder has not succeeded in acquiring 90% of a corporation's shares, various techniques - of which the amalgamation squeeze is perhaps the most common - may be used to eliminate minority shareholder interests.[114] Given that a specific 90% threshold is prescribed for purposes of the statutorily sanctioned corporate law compulsory acquisition rules, some early court decisions questioned the legality of amalgamation squeeze transactions completed in circumstances when the compulsory

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[112] The reference to "rules" here is used somewhat loosely; Policy 9.1 was promulgated before the Ontario Securities Commission was granted its current rule-making powers.
[113] See, e.g., *Canada Business Corporations Act,* s. 206.
[114] For a description of the amalgamation squeeze technique, see Christopher C. Nicholls, *Corporate Finance and Canadian Law* (Toronto: Carswell, 2000) at 310.

acquisition technique was not available.[115] Indeed, the Director under the CBCA, in a policy statement in 1989, indicated that such transactions were impermissible under the CBCA. However, such transactions have now become an accepted part of the Canadian M&A landscape. The CBCA Director has long since repealed the 1989 policy statement and, in its place, issued a policy indicating that such going-private transactions will generally be acceptable provided they are undertaken in accordance with applicable provincial securities rules of which OSC Rule 61-501 is a primary example.

Second, the exemptions provided by Rule 61-501 from the formal valuation (s. 5.5 (2)) and minority approval requirements (s. 5.7 (2)) for related-party transactions below a certain size, relative to the issuer's market capitalization, may not provide adequate protections for minority shareholders in all cases. Since the potential abuses that may arise in connection with related-party transactions merit a relatively greater degree of regulatory concern in Canada, a careful revisiting of Rule 61-501 may be in order. At the same time, it is not clear that it is necessary or advisable to add additional layers of detailed rules and procedures to the existing already-detailed provisions of Rule 61-501; indeed, a rules-based approach is inevitably more cumbersome and more prone to both errors and omissions than a principles-based model, as the extensive criticism by practitioners of earlier versions of Rule 61-501 revealed. Accordingly, it is recommended that Rule 61-501 might profitably be re-evaluated with a view to determining the extent to which its current rules-based approach might be effectively supplanted with more a principles-based approach to regulating related-party and going-private transactions in particular. A Task Force Member has noted that there are sensible reasons that certain transactions are exempt from Rule 61-501, that the availability of appropriate exemptions provide material cost savings for issuers, and, accordingly, that any review of Rule 61-501 must be undertaken with a view to "reducing administrative burdens and costs." I agree.

<u>**Recommendation #4:**</u> **The regulatory emphasis on scrutinizing related-party and going private transactions reflected in OSC Rule 61-501 is sensible in principle. However, it is not entirely clear that the rules-based approach of Rule 61-501 offers the optimal means of regulating such transactions. Rule 61-501 should be carefully reviewed with a view to ensuring optimal protection of minority shareholders within a framework that minimizes administrative hurdles and costs, especially for small issuers.**

[115] See, e.g., *Carlton Realty Company v. Maple Leaf Mills Limited,* [1978] OSCB 305; *Alexander v. Westeel-Rosco* (1978), 22 O.R. (2d) 211; *Burdon v. Zeller's Limited,* (1981), 16 BLR 59.
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Further, to the extent that aggrieved minority shareholders in certain cases must look chiefly to corporate law protections, such as the oppression remedy available under most Canadian corporate law statutes,[116] recent experience suggests that further legislative or regulatory attention may be warranted to ensure adequate protection for the interests of minority shareholders of public corporations with a dominant shareholder. In at least one recent Ontario case, the shareholder of a public company successfully used the oppression provisions of the CBCA to obtain a remedy in the case of an impugned related-party transaction.[117] However, the recent controversial decision of the Ontario Court of Appeal in *Ford v. Omers,*[118] even if jurisprudentially defensible, does seem to reveal at least some weakness in the framework for protection of the interests of minority shareholders in the context of squeeze out transactions. The current controversy surrounding the proposed take-over bid and going-private transaction with respect to Sears Canada may also provide an occasion for regulators or the courts to provide additional jurisprudential guidance with respect to the conduct of such transactions. However, clear, nationally consistent regulation of such transactions could provide enhanced certainty for issuers and controlling shareholders and improved clarity as to the rights and remedies of minority shareholders.

Modified Public Offering Rules

Last year, the SEC launched an important series of "sweeping changes"[119] to the U.S. public securities offering process.[120] In the coming months Canada's regulators will be called upon to consider how and whether to respond to this key U.S. securities initiative. One of the principal modifications effected by these recent U.S. reforms was the creation of a new category of securities issuers: "well-known seasoned issuers" (WKSI). WKSIs, under the new rules, are entitled to so-called "on demand" registration. They may file shelf registration statements in connection with the issue of securities that are effective immediately upon filing (i.e., with no waiting period, and no vetting by securities regulators.) As the name indicates, WKSIs are the largest and most widely followed public companies. Generally speaking, a

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[116] See, e.g., CBCA, s. 241.
[117] *Catalyst Fund General Partner I Inc. v. Hollinger Inc.* (2004), 1 B.L.R. (4th) 186 (Ont. Sup. Ct.), affd [2006] O.J. No. 944 (C.A.).
[118] *Ford Motor Company of Canada Limited v. Ontario Municipal Employees Retirement Board et al.*(6 January 2006) C41312 & C41450 (Ont. C.A.), available online at: <http://www.ontariocourts.on.ca/decisions/2006/january/c41312.pdf>.
[119] Curtis L. Mo, "Securities Offering Reform: Sweeping Changes to Public Offering Process Take Effect on December 1" (Wilmer Cutler Pickering Hale and Dorr, LLP, September 2005) in 37th Annual Institute on Securities Regulation, Vol 1 (New York: Practising Law Institute, 2005) 1115.
[120] SEC Release No. 33-8591 (July 19, 2005).

WKSI is an issuer having a worldwide market value of its outstanding equity securities of at least US$700 million. The SEC indicated that such issuers, in 2004, constituted about 30% of all U.S. listed issuers. [121]

Introducing a similar "on-demand" prospectus filing rule in Canada would first require regulators to determine precisely how large a company would need to be to be considered a Canadian WKSI. If the market capitalization threshold for achieving WKSI status were established at a level intended to ensure that Canadian WKSIs constituted roughly the same proportion of Canadian public companies as U.S. WKSI's constitute of U.S. public companies (about 30%), then a Canadian WKSI would be a company with a market capitalization of approximately $82 million. To place this number in perspective, it should be recalled that the in the Final Report of the Advisory Committee on Smaller Public Companies in the U.S., it was suggested that, in the United States, any company with a market capitalization of less than US$128.2 million ought to be regarded as a "micro-cap" company. In other words, a significant portion of "well-known seasoned (Canadian) issuers" would actually be considered micro-cap companies by U.S. standards.

However, if, instead, a market capitalization threshold of, say, $700 million were chosen (an amount still materially lower than the U.S. WKSI threshold of US$700 million), fewer than 9% of Canadian issuers would be eligible for the special accelerated filing regime.

There are, of course, many more significant issues raised by the prospect of on-demand registration than the question of firm eligibility. In particular, concerns have been raised by industry practitioners about how such a system would affect the performance by underwriters of their traditional "gatekeeping" role if the prospectus due diligence process were to be truncated.[122] It is not obvious, however, that this issue ought to be of any less concern to U.S. issuers, investors and underwriters: distinctions between the U.S. and Canadian markets would not appear to explain varying regulatory views as to the value of due diligence in connection with a public offering.

Indeed, the gatekeeping function performed by underwriters may well be the most significant aspect of the public offering process since the value of the prospectus itself to investors has often been questioned. As the late Merton Miller, a Nobel Laureate in Economics once wryly commented:

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[121] Ibid.

[122] One is also mindful of the related issue of potential underwriter liability, especially in light of the decision of Judge Denise Cote in *Re Worldcom Inc. Securities Litigation* 346 F. Supp. 2d 628 (S.D.N.Y. 2004).

> "It's not clear, of course, as a matter of purely scientific evidence, whether the SEC's disclosure rules really ever *have* saved anybody from a bad investment or even that an SEC prospectus is readable by anyone other than a plaintiff's lawyer looking to levy some extortion on a luckless corporation willing to settle rather than fight. But it's hard for anyone, except perhaps a cynical academic, to argue against the proposed therapeutic value of disclosure."[123]

Yet, the traditional regulatory emphasis on the public offering process seems largely misplaced. As the Allen Committee noted almost 10 years ago,[124] most Canadian investors today acquire their shares in the secondary markets rather than in the primary markets; and issuer-based, rather than transaction-based, disclosure would allow issuers, and dealers, to finance more quickly and so potentially lower Canadian firms' cost of capital. The recent introduction in Ontario of statutory civil liability for continuous disclosure facilitates the move away from the traditional emphasis on the prospectus, and the recent relaxation of the eligibility rules for use of the short-form prospectus[125] suggest further encouraging movement toward an issuer-based disclosure system. It is suggested that movement in this direction could offer significant benefits to issuers with little or no material risk to investors, and to the extent that new streamlined offering rules in the U.S. provide advantages for U.S. issuers, Canadian regulators ignore such advances at their peril.

Recommendation #5: Consideration should be given to shifting regulatory emphasis away from the public offering process, and further toward issuer-based regulation.

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[123] Merton H. Miller, *Merton Miller on Derivatives* (New York: John Wiley & Sons, Inc.) at 73.
[124] TSE Committee on Corporate Disclosure, "Responsible Corporate Disclosure: A Search for Balance" (March 1997).
[125] NI 44-101.

6. Conclusion

This paper has intended to survey the distinguishing features of Canada's capital markets and to suggest, at least in a very broad way, how a consideration of those features might be relevant when setting priorities for the focus of Canadian capital market regulation, when considering appropriate responses to foreign (especially U.S.) regulatory initiatives, and when assessing and formulating the content of Canadian securities regulation more generally. The paper has deliberately avoided any comment on possible reforms to Canada's securities regulatory infrastructure. Specifically, the familiar question of whether or not Canada ought to have a national securities regulator has not been discussed here. (There have been more than enough studies, reports, commissions, and "blueprints" on that topic produced in Canada already).

This focus on the Canadian securities regulatory *product*, rather than the regulatory *infrastructure* necessarily implies a more limited range of legal and policy recommendations since the primary concerns of securities regulators in every jurisdiction with well-developed capital markets are similar. Furthermore, only suggestions specifically linked to various distinguishing features of Canada's capital markets have been offered here since it is understood that this paper is only one small part of a larger regulatory review project. Needless to say, many other fundamental improvements to Canadian securities regulation might well have been proposed that are not particularly linked to peculiar features of Canada's capital markets.

Finally, in brief, the dominant characteristics of Canadian capital markets suggest that Canadian securities regulation, going forward, should be crafted with an eye to the following considerations:

- Tracking the U.S. rules-based securities regulatory model is frequently unnecessary and often undesirable. This is so not because of any specifically demonstrated weaknesses in U.S. regulatory practices, but rather because a more flexible regulatory approach may offer a more effective way for Canada's generally smaller companies to compete. Larger Canadian companies wishing to "opt in" to a more extensive (if more expensive) regulatory regime could do so by, for example, electing to list on larger U.S. exchanges. (Needless to say, companies could always voluntarily adopt more stringent governance practices, whether or not required to do so by exchange rules, corporate law, or securities regulation. However, voluntary adoption of such rules - in the absence of a credible bonding mechanism such as a decision to adhere to the rules of a particularly rigorous stock exchange or a jurisdiction with more "onerous" securities regulation -

cannot be expected to signal to existing and prospective investors a credible commitment to maintaining high standards.)

- When undertaking the classification of Canadian companies by size (whether for purposes of determining the availability of regulatory exemptions for larger firms or for the purpose of determining the eligibility of small firms for relief from disproportionately expensive regulatory burdens) a market capitalization test, rather than a test based on the Canadian exchange on which a public company has chosen to list its shares should be considered.
- The predominance of controlled corporations suggests that Canadian securities regulation should be relatively more focused upon preventing the abuse of minority shareholders of public companies that may arise in connection with going-private transactions, related-party transactions, and unlawful insider trading. The number of small, thinly traded Canadian corporations further suggests that share price manipulation ought to be a key securities regulatory focus.
- Improving the quality of continuous disclosure - including ensuring that strong incentives exist for issuers to comply with their disclosure obligations - complements a welcome move toward a more issuer-based regulatory regime.

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