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Reflections on the Recommendations of the Task Force to Modernize Securities Legislation in Canada: A Retail Investor Perspective

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REFLECTIONS ON THE RECOMMENDATIONS OF THE TASK FORCE TO MODERNIZE SECURITIES LEGISLATION IN CANADA: A RETAIL INVESTOR PERSPECTIVE

*Paul Halpern and Poonam Puri**

I. INTRODUCTION

In 2005, the Investment Dealers Association of Canada funded a task force to review and recommend changes in securities legislation in order to promote more effective Canadian capital markets. An important factor motivating the establishment of the Task Force was the observation in the academic literature that Canada had a higher cost of capital than other countries after accounting for risk. This “Canada Discount” meant that Canadian companies had to pay more for capital, and thus investment decisions were negatively affected. The issue that the Task Force was interested in pursuing was the extent to which changes in regulation could reduce or eliminate the discount, or even shift the situation to a “Canada Premium.”

The Task Force to Modernize Securities Legislation in Canada deliberated until October 2006 when the report and recommendations were released.¹ Integral to the Task Force’s deliberations was the funded research undertaken by academics and to a lesser extent, practitioners, from around the world. There were 30 research papers prepared on a range of topics. The final 65 recommendations were informed by this research. However, not all of the research topics were addressed in the recommendations. This research effort was unprecedented in Canada.

Fundamental to the Task Force’s deliberations was the trade-off

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1. *Canada Steps Up: The Report of the Task Force to Modernize Securities Legislation in Canada* (Toronto, 2006), available online: <www.tfmsl.ca> (The Report).

between using markets to discipline the capital markets and requiring specific legal rules to protect investors. The former is more effective in a situation where investors are well informed and is beneficial to issuers (and ultimately shareholders) in terms of reducing costs and speeding access to markets. The latter approach is more costly to issuers and to market operations but reduces the costs to uninformed investors, the bulk of whom are retail investors. The Task Force was very sensitive to the role of the retail investor in capital markets but also was concerned about the costs that their protection imposed on the functioning of capital markets.

For this paper, we were asked by the conference organizers to focus on the *retail investor*. This mandate forced us to make some difficult choices regarding topics to include and exclude. For example, there was a lengthy and important discussion of Principal Protected Notes (PPNS) in The Report.² We do not discuss PPNS in this paper. There are a number of other important issues that were discussed by the Task Force that we are similarly unable to consider. We decided to concentrate on certain fundamental areas for retail investors and for capital market performance and regulation. Our focus is on four areas. Part II of the paper considers enforcement, which has an impact on the operation and opinion of both local and foreign investors on the effectiveness of our market; Part III reviews the debate on rules versus principles in securities regulation. Part IV discusses financial literacy and its implications for disclosure; Part V reflects on the influence and regulation of closely held companies, specifically dual class and pyramid structures. This article reviews and comments on some of the recommendations of the Task Force in these areas. The Task Force did not spend much, if any, time on making recommendations on at least one of these areas, closely held corporations, although it is an important area of policy concern in our capital markets, and it is for that reason that we discuss it here. The article also highlights areas for further research and analysis for each of these topics.

II. ENFORCEMENT OF SECURITIES LAWS

The Task Force addressed the important issue of the extent to which existing Canadian securities laws are enforced effectively. Enforcement was relevant to the Task Force because it relates to the

2. PPNS are securities in which retail investors invest heavily and where, in some situations, there are embedded hedge funds, yet due to an exemption, are regulated by the wrapper for the securities; the wrapper is typically a debt instrument.

enhancement of the competitiveness of Canadian capital markets and fundamentally affects investor confidence. One common recurring theme that was noted by the Task Force was the perception that Canadian markets lacked vigour in the enforcement of securities laws.³ Public enforcement is particularly important to the retail investor who may not have the resources, expertise or ability to pursue claims through private enforcement mechanisms. The ability of the regulatory system to address both larger market concerns as well as the more particular needs of retail investors is challenging. As a result, it is interesting to see how the Task Force approached the general question of enforcement.

The Task Force commissioned several research papers on the topic of enforcement, with a particular focus on public enforcement by securities regulators. There was very little attention paid by the Task Force to private enforcement mechanisms including compensation mechanisms for investors in relation to the client-advisor relationship.⁴ However, research studies such as the Cory and Pilkington paper⁵ discuss restitution and civil liability as a possible deterrence mechanism. In addition, the Condon and Puri paper discussed, among other issues, the advisor-client relationship and the impact that it can have upon both enforcement and compliance.⁶ While private enforcement and various perspectives of compliance can be seen to be a significant consideration in an overall and complete conception of enforcement, the Task Force did not pursue these potentially significant topics of discussion from the research commissioned. Furthermore, the topic of self-regulatory organizations (SROs) was not addressed at great length by the Task Force. The recommendations made by the Task Force are unclear about what role the SROs should play in the Canadian capital markets and how their role can be improved.

3. For example, see Luzi Hail and Christian Leuz, "International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?" (2006), 44 *J. of Accounting Research* 485 (observing that the cost of equity capital is 25 basis points higher in Canada than in the United States); also see Michael R. King and Dan Segal, "Valuation of Canadian vs. U.S. Listed Equity: Is there a Discount?" (2003) Bank of Canada Working Paper 2003-6 (concluding that Canadian public companies are valued significantly lower than those in the United States while attempting to control for a number of variables).
4. Civil liability has often come up as a topic of discussion, for example see Ontario Ministry of Finance, *Five Year Review Committee Final Report - Reviewing the Securities Act (Ontario)* (Toronto, Queen's Printer for Ontario, 2003), pp. 130-33 (discussing civil liability and its role in enforcement).
5. See *infra*, footnote 12.
6. M. Condon and P. Puri, "The Role of Compliance in Securities Regulatory Enforcement", *The Report, supra*, footnote 1, at volume VI.

Even with the focus on public enforcement, it should be noted that the Task Force's primary interest was with respect to enforcement in terms of formal mechanisms and inputs and outputs of the enforcement departments. Thus, the Task Force did not fully consider the entire spectrum of regulation, from rule-design to compliance to enforcement, and this is certainly an area ripe for further research and analysis. For example, one important issue is the possibility of substitution effects. A review of substitution effects would postulate whether less back-ended enforcement may still equal the same level of compliance if more efforts were taken earlier in the spectrum to ensure compliance.⁷ This could be bolstered by a careful review of possible innovations in the design and implementation phases of enforcement.⁸ Thus, the Task Force's recommendations could be further enhanced by taking a broader view of securities regulation.⁹

As was mentioned in the report, international investors may attach a "Canadian risk premium" when investing in Canadian equities. Vigorous enforcement may enhance the credibility of Canadian securities regulation and, in turn, help attract risk-adverse investors to Canadian markets. Research conducted by Professor Uptal Bhattacharya¹⁰ investigated the efficacy of securities law enforcement from both an international and a local level. His survey of the literature¹¹ finds that while securities laws exist in *most* countries, they are not enforced in *many* countries. Other findings include the fact that countries with stricter enforcement of securities laws have lower cost of capital and more fluid markets. Bhattacharya also points to some evidence that it is better to have no insider trading law than to have an insider trading law that is not enforced. Overall,

7. See Poonam Puri, "Enforcement Effectiveness in the Canadian Capital Markets" (Capital Markets Institute, 2005) [unpublished, archived with authors].

8. For example, see Christine Parker, "Reducing the Risk of Policy Failure: Challenges for Regulatory Compliance" (2000) Organisation for Economic Co-Operation and Development (author carefully reviews compliance failures as well as many different innovative approaches towards enhancing compliance).

9. See Mary Condon, "Rethinking Enforcement and Litigation in Ontario Securities Regulation" (2006), 32 *Queen's L.J.* 1 (author reviews policy issues through public, criminal and quasi-criminal sanctions, including civil remedies, and proposes that both public and private mechanisms may be interdependent).

10. See U. Bhattacharya, "Enforcement and its Impact on Cost of Equity and Liquidity of the Market", *The Report, supra*, footnote 1, at volume VI.

11. His survey includes a review of some key studies such as Luzi Hail and Christian Leuz, "International differences in the cost of equity capital: do legal institutions and securities regulation matter? (2005) [unpublished, archived at SSRN], online: ECGI - Law Working Paper No. 15/2003 <<http://ssrn.com/abstract=641981>>. This paper studied over 40 countries and came to the conclusion that countries with a strict enforcement of securities laws have a lower cost of capital.

research commissioned by the Task Force supports the conclusion that enforcement of securities laws reduces the cost of capital and in turn increases liquidity in the capital markets.

Although it is clear that improvements to enforcement of Canadian securities laws are required, the Task Force was also sensitive to the fact that Canada has its own unique circumstances, culture and traditions. Accordingly, there was attention given to the fact that U.S. enforcement successes should not lead Canada to blindly transplant U.S. enforcement models without regard to Canada's own circumstances. Thus, the Task Force commissioned research from The Honourable Peter Cory and Professor Marilyn Pilkington¹² (the "Cory and Pilkington Paper," which will be discussed later) to look into questions such as public concerns about enforcement, public policy goals, procedural issues, the balance between public and private enforcement¹³ and the balance between regulatory and criminal enforcement.¹⁴

The Task Force also commissioned research to draw comparisons between Canadian and U.S. enforcement apparatuses.¹⁵ Professor Howell Jackson compared the budgets and staffing levels for securities regulators in the United States and Canada, collected data on enforcement activity in Canada and followed that with a comparison of enforcement activity between the United States and Canada. Professor Jackson found that:

- When adjusted for population, GDP or market capitalization, the levels of Canadian supervisory budgets and staffing levels do not seem wildly out of line and may actually be more intensive than the United States.

12. P. Cory and M. Pilkington, "Critical Issues in Enforcement", The Report, *supra*, footnote 1, at 171, volume VI. Their views were also formed with the assistance of a board of experienced Canadian securities practitioners.

13. It should also be noted that some studies have suggested that public enforcement does not necessarily benefit stock markets as much as disclosure and laws facilitating private enforcement. See Rafael La Porta, Florencio Lopez-de Silanes and Andrei Shleifer, "What Works in Securities Law" (2006), 61 J. of Finance 1.

14. It should be noted that the Task Force was informed by a number of research studies. One research study examined the effectiveness of broad principles versus highly detailed rules (see L. Cunningham, "Principles and Rules in Public and Professional Securities Law Enforcement: A Comparative U.S.-Canada Inquiry", The Report, *supra*, footnote 1, at volume VI). Another study examined the development of "compliance cultures" and useful regulatory techniques for fostering compliance (see M. Condon and P. Puri, "The Role of Compliance in Securities Regulatory Enforcement", The Report, *supra*, footnote 1, at volume VI).

15. See H. Jackson, "Regulatory Intensity in the Regulation of Capital Markets: A Preliminary Comparison of Canadian and U.S. Approaches," The Report, *ibid.* at volume VI.

- However, Canadian regulatory budgets per staff member are lower than their counterparts in the United States, with U.S. budgets per staff member being about 60% higher. There does not seem to be evidence that more Canadian personnel is needed, though one may wish to revisit the issue of budget levels.
- For the years 2002-2004, Canadian public enforcement activity was much lower than that of the United States, even when one performed scaling adjustments. However, more recent data indicates that, given plausible scaling factors, Canadian public enforcement is roughly comparable to that of the United States (though private enforcement is still much lower). Nevertheless, Professor Jackson cautions that drawing comparisons is difficult since one could compare based on many different factors such number of actions, level of market capitalization, monetary fines imposed etc.
- Overall, in the past few years there has been some volatility in Canadian sanctioning practices with an upward trend. Professor Jackson notes that more work needs to be done to understand whether the trends are temporary or permanent.
- Private enforcement is substantially less in Canada but Professor Jackson cautions against moving towards a U.S. system of class actions as there are many reasons to believe that this form of the U.S. litigation system is inefficient and inequitable.

Professor Jackson's study seems to suggest that the perceived differences between the vigorousness of enforcement of Canada and the United States may not necessarily be heavily tied to funding or staffing levels as some might be tempted to hypothesize. His approach is a first step towards comparative analysis between Canada and the United States. It should be noted that his research focused essentially on hard inputs (financial funding levels and human resources) and outputs (enforcement activities). Further research on other important factors such as practices in the exercise of discretion in bringing enforcement proceedings and non-enforcement compliance techniques is the natural next step; until then, one should be cautious in drawing any causative inferences between levels of funding and staffing on the one hand and levels of enforcement activity on the other hand. While funding and staffing may play an important role in levels of enforcement, this may be an

incomplete picture given the different contexts of Canada and the United States.¹⁶

Another natural next step for future research is to consider how enforcement *effectiveness* can actually be measured. This analysis must go beyond a comparison of monetary inputs and outputs in terms of cases pursued or sanctions levied. How can behavior modification, resulting from enforcement actions, actually be measured? How can the level of compliance with rules actually be evaluated?

The Task Force was greatly assisted by the Cory and Pilkington Paper and for the most part, agreed with their recommendations. Their key recommendations were:¹⁷

- *Priorities and Performance*: securities regulators and enforcement agencies should establish a set of priorities and regularly evaluate whether enforcement has attained stated objectives.
- *Investigation*: A study should be conducted to assess needs for police services in investigation of capital market crimes and the various contributions to be made by municipal, provincial and federal police services. IMET should continuously develop and maintain expertise required to conduct complex capital-market offence investigations. The IMET should be expanded to conduct all necessary investigations or the capacity of other police forces should be enhanced in order to address the cases not addressed by the IMET. Within each IMET and securities regulator there should be a Senior Independent Review Officer (a SIRO) to provide focus, supervision and accountability for strategic decisions in an investigation. The SIRO would have a status similar to a Securities Commissioner and such persons might be found among the senior ranks of counsel in private practice or the prosecution service. In particular, they may be found among individuals recently retired who remain at the peak of performance, and can bring their abilities and experience to bear.
- *Prosecution*: The SIRO should have independent authority to determine whether a matter should be sent for a hearing by

16. For a closer look at private vs. public enforcement in the United States alone, see James D. Cox and Randall Thomas with the assistance of Dana Kiku, "Public and Private Enforcement of the Securities Laws: Have Things Changed Since Enron?" (2005), 80 Notre Dame L. Rev. 893.

17. This is a summary only. More detailed discussion can be found in The Report, *supra*, footnote 1.

a securities tribunal or for prosecution as a provincial offence. It may be appropriate, where a provincial prosecution has been authorized, to authorize counsel retained or employed by the securities regulator to prosecute it.

- *Adjudication*: The adjudicative functions of securities commissions should be transferred to independent tribunals composed of individuals with expert knowledge of law, procedure and the operation of capital markets. The National Judicial Institute should prepare judges in the adjudication of complex capital market offences. Finally, the Task Force has recommended the creation of a separate capital markets court to which jurisdiction, both provincial and federal, is ceded. Such a court would have jurisdiction over all capital market regulatory offences.¹⁸
- *Penalties and Orders*: Legislatures should consider enacting laws similar to s. 380 of the Criminal Code of Canada, specifying the aggravating circumstances that must be taken into account in imposing a sentence for offences under securities legislation and the non-mitigating factors that must not be taken into account. Penalties and orders should be harmonized across the country yet applied with regional sensitivity. Provisions governing costs should be reviewed, considering best practices of other jurisdictions, and harmonized.
- *Redress for Investors*: Securities regulators should consider applying to court more frequently for restitution, compensation and damages on behalf of aggrieved persons. Consideration should be given to authorizing security tribunals as well as courts (adjudicating under provincial or criminal legislation) to order compensation or restitution under a fair set of rules.
- *Self-regulatory Organizations*: The roles and jurisdiction of SROs should be reviewed. Such a review would consider, with respect to SROs, the applicability of the Canadian Charter of Rights and Freedoms, powers to obtain documents and call witnesses, immunity from civil liability, and applications for a court monitor.
- *National Management of Enforcement*: Regardless of

18. In making these recommendations, the Task Force was, however, mindful of the more gradual recommendations in the Cory and Pilkington Paper in this regard, which stated that every reasonable effort should be made to accomplish the same result within the current court system.

whether Canada adopts a unified or harmonized approach to securities regulation, it is fundamentally important that enforcement be managed on a national basis to ensure the effective use of resources, the development and deployment of expert skill and knowledge across the country, and the independence and accountability of enforcement processes.

Despite the breadth of these recommendations, many challenges remain for the future. It is not fully clear how these recommendations ought to be implemented nor is it apparent how some of these recommendations might harmonize with each other. For example, while it was recommended that enforcement be managed on a national basis, it is uncertain what type of organization or entity would direct such management.¹⁹ And, as will be discussed later, the balance between criminal investigative powers and self-regulatory investigations will have to be carefully balanced in light of protections afforded under the Canadian Charter.

However, since the release of the Task Force report, a number of important developments have taken place. Following up on recommendations relating to IMET, there has been a new special advisor appointed by the federal government to assist IMET in enhancing its effectiveness.²⁰ On another front, the Securities Fraud Enforcement Working Group was struck shortly after the Task Force Report was released; this group recently reported back to the provincial ministers of justice and made recommendations such as more resources and better legal tools for investigators.²¹ As well, drawing on the concept of the Senior Independent Review Officer (SIRO) recommended by the Allen Report, the OSC has announced the appointment of a special advisor on ethics and enforcement, to assist the Chair and Executive Director of the OSC on the direction of enforcement investigations.²² It is interesting to note that the SIRO concept envisioned by the Task Force would have involved

19. See James C. Baillie, "The Wise Persons' Committee Report: Another Attempt to Revolutionize Canadian Securities Regulation" (2004), 40 C.B.L.J. 434 at pp. 434-39 (an interesting discussion of past efforts towards a national regulator and some more detailed insights as to the various types of arrangements that may be attempted as we strive for more unification for securities regulation in Canada).
20. Department of Finance (Canada), News Release, "Senior Expert Advisor to RCMP Named to Bolster Fight Against White Collar Crime" (May 14, 2007), online: Department of Finance <<http://www.fin.gc.ca>> (both the Honourable Stockwell Day, Minister of Public Safety and the Honourable Jim Flaherty, Minister of Finance, announce that Nicholas Le Pan has been appointed as an expert advisor to the RCMP on its IMET).
21. Madhavi Acharya-Tom Yew, "Lawyer defends OSC's record on crime", *Toronto Star* (November 28, 2007).
22. OSC, News Release (November 28, 2007).

significant co-ordination among IMET and provincial/territorial securities commissions; seemingly recognizing the challenges and delays associated with such co-ordination, the OSC decided not to wait and implemented this valuable position at its own organization.

The Task Force's Report and recommendations are a healthy addition to the currently evolving debate on enforcement of securities laws in Canada. Although the connection between strong securities laws enforcement, on the one hand, and lower cost of equity capital on the other hand may seem intuitive to some, the research studies commissioned by the Task Force lend a welcome empirical foundation to this proposition. It would seem that this would be an important point to address given the "Canadian discount" that seems to be facing Canadian equity markets.

Rather, a reinvigorated Canadian securities enforcement model may well depend more upon both the approach taken by Canadian securities officials as well as the structure of the Canadian securities enforcement landscape. The Cory and Pilkington Paper pick up well on this theme and make numerous insightful recommendations that have the effect of both rationalizing and consolidating focus on securities enforcement (for example, through the use of an SIRO) while, at the same time, increasing the magnification and power of that focus such as through increased scope of IMET powers and capacity.

Overall, the Task Force Report provides a landscape review of the current situation with respect to Canadian securities law enforcement and guidance towards where effective Canadian securities enforcement may lie in the future. There are, however, a few important questions that must still be addressed in the context of any attempt to reinvigorate Canadian securities law enforcement.

One persistent and far-reaching fact about Canadian securities enforcement is that it is seriously fragmented with its 13 separate securities commissions and regulators.²³ While the Task Force and Cory and Pilkington Paper did not go so far as to insist upon a single common enforcement body, a careful review of their recommendations leads one to the conclusion that those recommendations would be greatly enhanced by such a single unified entity. For example, IMET would not have to coordinate with

23. See Mary Condon, "The Use of Public Interest Enforcement Orders by Securities Regulators in Canada" in A. Douglas Harris ed., *WPC — Committee to Review the Structure of Securities Regulation in Canada: Research Studies* (Ottawa, Department of Finance, 2003), online: <http://www.wise-averties.ca/report_en.html>. In this study, it was noted that there was significant variation across the provinces in relation to infractions pursued to enforcement hearings.

as many different provincial bodies on its investigations if it could simply deal with one common enforcement body. In addition to increasing the potential efficiency of enforcement through a common enforcement body, it should not be overlooked that that single common enforcement body, as opposed to 13 disparate provincial bodies, may lead to the perception of a stronger and more unified approach to Canadian securities enforcement. This comes around full circle and may help address the “Canadian discount” problem that was alluded to in Professor Bhattacharya’s study.

Further challenges for the future also involve the question of appropriate scope of investigatory powers given the various different legal rules of evidence applicable to criminal versus administrative proceedings. This issue was clearly visited by the Supreme Court of Canada in the case of *R. v. Jarvis*²⁴ where the court held that if evidence was obtained in a regulatory investigation where the primary purpose of the investigation is criminal in nature, then such evidence could not be used in a subsequent criminal investigation. In a subsequent case²⁵ that considered the *Jarvis* decision in a securities context, the court emphasized that the key question is when, if at all, did an adversarial relationship crystallize? However, it is not necessary to be myopic and simply focus on the legal issue raised in these cases. There may be methods by which IMET and other enforcement agencies could be improved without raising issues related to the invocation of the power to compel testimony. For example, compensation and promotion changes as well as structural and organizational changes at IMET could increase efficiency and effectiveness.

Clearly, whether one contemplates the use of a single common enforcement entity or the current system of various different provincial enforcement entities working in a more harmonized fashion, it will be important to address exactly how investigations will be conducted and how information may be shared with respect to different types of investigations. We would also need to explore further the question of how information may be shared on an international basis, for example, in cooperation with a U.S. Securities and Exchange Commission (SEC) investigation.

In particular, future studies will have to closely address the issue of SROS and their investigative powers in light of the foregoing legal

24. [2002] 3 S.C.R. 757, 219 D.L.R. (4th) 233, [2003] 3 W.W.R. 197.

25. The decision in *Jarvis* was considered in a securities law context in the case of *R. v. Mercer* (2003), 223 Nfld. & P.E.I.R. 134, 103 C.R.R. (2d) 232 (S.C.), which was subsequently overturned by the Court of Appeal in *R. v. Mercer* (2005), 245 Nfld. & P.E.I.R. 50, 194 C.C.C. (3d) 370 (C.A.).

issues. Since SROs have a rather broad capacity to investigate, it will be critically important that SROs coordinate well with other entities or with a single common enforcement entity to ensure that any potential criminal investigations are not impaired or unduly prejudiced. In the end analysis, even if there is a single common enforcement entity, it may well be that criminal investigations will have to remain segregated from other activities simply due to the legal rules of evidence.

Finally, the suggestion that a securities regulator takes greater advantage of applying to court seeking a redress or compensation for aggrieved investors seems to be a plausible alternative to the stronger regime of private enforcement prevalent in the United States. Given that the Canadian legal environment has a different culture of litigation, the use of securities regulators for seeking restitution or compensation for aggrieved investors may be a better balance of the compensatory and deterrent features of the law in Canada, as opposed to a purely private adversarial model.

III. RULES VERSUS PRINCIPLES

Although the Task Force Report paid much attention to the topic of enforcement, there is also an important sub-theme addressed indirectly within the discussion of enforcement, *i.e.* rules versus principles. For the purpose of this article, this topic certainly merits its own independent discussion. The concept of rules as opposed to principles plays an extremely important role in any discussion of improving Canada's securities laws. In this context, "rules" refers to highly specific rules which guide how private actors should behave while "principles" refers to broad over-arching principles that generally guide private actors' behaviours. Although the topic of rules versus principles may seem at a theoretical level, distanced from the everyday lives of retail investors, the practical outcomes of this debate may have some significance nevertheless to the retail-investment sector. The approach adopted by regulatory authorities can be expected to have some impact on enforcement activities and correspondingly may affect retail investors through its overall structure.

More specifically, within the context of enforcement, the Task Force was concerned that the "contrary to the public interest" section of securities law may be abused. In particular, such provisions could be the basis of sanctioning market behaviour where there were no previous indications that such behaviour was viewed by regulatory authorities to be offensive (so-called "gotcha enforcement"). The

Task Force recommended that the “contrary to the public interest” provisions be used sparingly and, if the criticized behaviour has not been publicly identified in the past, the provision should only be used to discipline egregious behaviour. The “contrary to the public interest” provision is thus a general principle (as opposed to a specific rule) whose ambiguity and vagueness, if left unchecked, may serve to undermine just and fair enforcement.

In order to more fully explore the interplay between rules and principles, the Task Force commissioned a research study by Lawrence Cunningham.²⁶ In his research, Cunningham first explores from a more theoretical standpoint the traditional differences between rules and principles. He notes that the debate over whether laws should be best articulated as rules or principles has a rich jurisprudential and theoretical history far beyond the scope of his research project. That debate has taken many forms including the historical conception of law (as representative of hard rules) versus equity (as representative of principles of fairness). As a contextual backdrop, Cunningham cites famous works that address this classical debate such as works by Duncan Kennedy,²⁷ Ronald Dworkin²⁸ and more recent works.²⁹

Overall, he conceptualizes lawmaking as an exercise that often begins as a stated principle along with exceptions and limitations on the exceptions. In the process, a greater degree of specificity is brought to bear upon the process such that the law becomes more rule-like. Indeed, in his end analysis, Cunningham views “rules” and “principles” as points of extreme along a continuum of the law with the observation that the majority of securities laws and regulations in

26. Lawrence Cunningham, “Principles and Rules in Public and Professional Securities Law Enforcement: A Comparative U.S. — Canada Inquiry”, The Report, *supra*, footnote 1, at volume VI.

27. Duncan Kennedy, “Form and Substance in Private Law Adjudication” (1976), 89 Harv. L. Rev. 1685 (a ground breaking and influential article that also contributed heavily to the school of Critical Legal Studies. In this article, Kennedy examined the form and substance of contract law and noted that they are related and noted that the contradictory rhetoric of rules and standards is tied to contradictory commitments to individualism and altruism).

28. Ronald Dworkin, “Hard Cases” in *Taking Rights Seriously* (Cambridge, Harvard University Press, 1977) (a classical treatment of the problem whereby Dworkin proposes that when a judge adjudicates a difficult decision, she/he attempts to choose the legal interpretation that best fits and justifies the existing legal landscape).

29. See John Braithwaite, “Rules and Principles: A Theory of Legal Certainty” (2002), 27 Austl. J. of Leg. Phil. 47; Cass R. Sunstein, “Problems with Rules” (1995), 83 Cal. L. Rev. 953; Louis Kaplow, “Rules and Standards: An Economic Analysis” (1992), 42 Duke L.J. 557 and Pierre J. Schlag, “Rules and Standards” (1985), 33 U.C.L.A. L. Rev. 379.

the United States and Canada reside somewhere in between the two endpoints of this continuum.

Moreover, in the theoretical component of his discussion, Cunningham notes that rules have the advantage of providing relative certainty and predictability while the disadvantage is that they could be “mere blueprints for evading their purposes” (through artful dodging of a rule’s spirit through literal compliance with its technical provisions). On the other hand, principles have relative capacity for exploiting advantageous situations while avoiding disadvantageous ones; the downside to principles is that they pose problems of uncertainty and *ex post* surprise.

Ultimately, Cunningham’s main point is that of balance. He stresses the need for balance between rules and principles. This balance turns on an ability to closely analyze certain given situations. He notes that this means determining which is more important within a given situation: predictability and certainty (which implies rules) or fairness and context (which implies principles). Accordingly, he concludes that when regulators decide to elevate either rules or principles over the other, careful attention must be paid to the consequences of doing so.

However, one must read Cunningham’s work very carefully. As mentioned before, he rightly takes a very nuanced view of “principles vs. rules” and emphatically states that these two terms are really opposite ends of the spectrum with most cases falling someplace in between. For that reason, it is surprising that the Task Force recommendations appear to view securities laws starkly as being either rule or principle based.³⁰ What is perhaps even more surprising is that the Task Force suggests a move towards a principle-based approach yet also indicates a preference away from “gotcha” legislation (*i.e.* laws without enough certainty to guide one’s conduct meaningfully). Given the uncertainty that often surrounds a principle-based approach, it is hard to reconcile this with an agenda that seeks to refrain from uncertain application of the law. This is certainly another area that is ripe for further research and analysis.

30. These issues all involve a more detailed examination of the concept of regulation, including compliance-based approaches as well as the more general idea of rules and principles as forming different spheres of regulation. For a “decentered” view of regulation see Julia Black, “Critical Reflections on Regulation” (2002), 27 *Austl. J. Leg. Phil.* 1, wherein the author attempts to develop a broader and more encompassing theory of regulation as opposed to traditional state-centered conceptions of regulation. In contrast, see Dimity Kingsford Smith, “What is Regulation? A Reply to Julia Black” (2002), 27 *Austl. J. Leg. Phil.* 37 at pp. 37-46. Also, for a review article of various different views on regulation see Steve Tombs, “Understanding Regulation?” (2002), 11 *Social and Leg. Stud.* 113.

Cunningham based his study on a number of empirical situations. His first study analyzes empirical information regarding enforcement actions by the SEC and the Canadian Securities Administrators (CSA). He classifies various types of laws along the rules-principles continuum, with insider trading and market manipulation laws being classified towards the principles end while securities offerings are towards the rules-based end. Disclosure regulation and accounting tends to be classified towards the centre of the continuum. According to his study, the evidence tends to indicate that both CSA and SEC members favour rules-based enforcement slightly; however, he also notes that a significant portion of cases are also principles-based. Comparing the SEC to the CSA, the SEC tends to exhibit slightly more activity enforcing principle-based laws than the CSA.

Cunningham then goes further and also compares the enforcement activity of the U.S. National Association of Securities Dealers (NASD) and Canada's Investment Dealers Association (IDA) in their roles as professional trade associations. Both the NASD and IDA are empowered to make and enforce securities regulations regarding their various members. Despite the fact that both the IDA and NASD have extensively detailed rules, Cunningham's study suggests that both organizations are heavily biased towards enforcing principles over rules.

The key observation here is that both SEC and CSA exhibit commonalities and, by the same token, both the NASD and IDA exhibit commonalities. This suggests that at least one defining and important variable is not so much the country of origin or written materials as it is the identity and position of the enforcer. In this case, the dichotomy seems to be public enforcer (SEC and CSA) preferring rules-based enforcement slightly versus professional self-policing enforcers (NASD and IDA) leaning heavily towards principle-based enforcement. One other important point made by this study is that it runs against the commonly held conception that U.S. securities laws are more rules-based and that Canadian securities laws are more principle-based. Quite simply stated, Cunningham's study does not support such sweeping generalizations.

A large part of the rules vs. principles debate has to be situated within Canada's future potential enforcement developments. In either case, it may well be that at least some aspects of Canadian securities law enforcement may take the form of rule-based laws. There are two main possibilities at the moment that should be considered. First, if Canada moves towards a common enforcement body, then a rule-based regime may help quiet fears of having too

much power reside in a single entity. In part, by taking away the inherent discretion that resides in the enforcer/decision-maker under a principles-based approach, greater confidence can be inspired in a common enforcement body by requiring adherence to transparent and predefined rules that can foster the certainty and confidence required for such a body. Or, using Cunningham's analysis, in this situation it may well be that a need for greater certainty is the variable that drives the reform process.

Second, if Canada decides to stay away from a common enforcement body in favour of more harmonized securities enforcement among the 13 securities regulators across the country, this too may require a more rules-based approach. In this case, the driving factor would be a desire for uniformity across the country and, in turn, uniformity would require that each jurisdiction be certain what standards and rules are being promoted in each other jurisdiction. Thus, this particular context would also emphasize certainty and tend to require rules-based approaches. Of course, this is not to suggest a false dichotomy of rules only or principles only. Rather, what is being suggested is that, in the short term, a slide along the continuum towards rule-based approaches may be expected under Canada's likely future enforcement reforms.

The distinction between criminal law and administrative/quasi-criminal law may also play an important role in determining whether laws are more rules based or principles-based. Criminal law has traditionally required a greater deal of certainty because it is thought that if an individual is to be exposed to potentially severe repercussions under criminal law, then the individual should be allowed to know clearly what the prohibited behaviour is. This would suggest that criminal sanctions require very clearly defined rules as opposed to principles. On the other hand administrative sanctions do not entail such severe repercussions and, as a result, a greater deal of ambiguity and vagueness of laws is tolerable under these circumstances. Given the importance of the distinction between criminal and administrative law, if there is a common enforcement body or harmonized enforcement between jurisdictions, there will have to be clear procedural rules that can distinguish between criminal and administrative proceedings.

IV. FINANCIAL LITERACY AND DISCLOSURE

The recommendations made by the Task Force in Volume I, Chapter 4 were designed to address the issue of "what should I buy" in the context of the retail investor. In this chapter the Task Force

addressed three questions: (1) how do investors make investment decisions; (2) is the form of presentation of public-company disclosure adequate for investors' needs to make these decisions; and (3) what opportunity does an investor have to be informed prior to purchase. These questions were addressed in research undertaken for the Task Force by Deaves *et al.*³¹ and their findings informed the recommendations in this section.

The Deaves research had two parts. The first, which is of direct interest to this article, was an online survey of 1,600 retail investors of various levels of sophistication. The second was an interview of 20 institutional investors. The retail survey addressed issues such as "the knowledge level of investors and the extent to which they are subject to behavioural biases; what information, whether mandated corporate disclosure or information provided by third parties, is used and the openness of investor to electronic disclosure."

These questions have always been relevant but take on added emphasis with the importance of RSP investments and the move by corporations from defined benefits plans (where decisions are made for the employees and the risk of not meeting a pension promise is borne primarily by the corporation) to defined contribution pension plans (where investment decisions are made by the employees and the risk of market fluctuations and poor investment decisions in terms of asset allocation and diversification are borne directly by the employee at retirement).

Although not directly tied into all of the discussion in this chapter of the Task Force report, behavioural finance takes on great importance in the recommendations and has implications for their effectiveness in improving retail (and even institutional) investment decisions.

In considering how financial markets value securities there are two alternative paradigms. The received paradigm, certainly among academics and those who use financial economic valuation models, is the Efficient Markets Hypothesis (EMH). Under this hypothesis markets fully and instantaneously incorporate all information into market prices in an unbiased way. Underlying this concept is the assumption that "market participants are rational economic beings, always acting in self-interest and making optimal decisions by trading off costs and benefits weighted by statistically correct probabilities and marginal utilities."³² The alternative approach recognizes that

31. Richard Deaves, Catherine Dine and William Horton, "How Are Investment Decisions Made", The Report, *supra*, footnote 1, at volume 2.

32. Andrew Lo, "Reconciling Efficient Markets with Behavioral Finance: The Adaptive Markets Hypothesis" (2005), 7 *The J. of Investment Consulting* 1.

human behaviour deviates from rational decision-making under uncertainty. Unlike the EMH, behavioural finance does not have a set of fundamental axioms from which all behaviour can be generated. It is rooted in empirical observation and controlled experiments. While leading to interesting implications, there is no unified theory. These approaches lead to different views on how capital markets incorporate information and how securities are priced in capital markets.

Fortunately for the purposes of the Task Force deliberations, there was no need to enter this debate. There is no doubt that irrational behaviour does occur and individual (retail) investors, while perhaps not establishing market prices, inflict wealth losses on themselves by their financial decisions. The extent of these biases has an influence on a number of important issues in financial market oversight such as disclosure practices and the importance and efficacy of investor financial literacy.

Behavioural finance literature has progressed rapidly since 1974 with the original Tversky and Kahneman research. Researchers have identified a number of biases and have subjected them to experiments and empirical analyses. At least one researcher has argued that there is a neuroscience perspective such that it is very difficult to change certain types of behaviour.³³ The biases included procrastination and status quo bias, hyperbolic discounting,³⁴ loss aversion (prospect theory) and overconfidence. Many of these biases arise from bounded rationality and choice overload.³⁵ The implications for decision-making are numerous but two important ones are a lack of diversification in portfolio selection and poor asset allocation.³⁶

The Deaves study confirms that retail investors in the survey suffer from many of these biases and end up making incorrect decisions with respect to diversification and asset allocation. Generally most of the investors had a low level of investment knowledge and made decisions with the assistance of wealth advisers. This latter observation was also confirmed in an investor survey undertaken for the Investment Funds Institute of Canada (IFIC).³⁷

33. *Ibid.*, at pp. 26-29.

34. Under uncertainty, individuals drastically reduce the weight of future outcomes in decision-making. Thus both good and bad outcomes will have less impact than current ones.

35. An interesting observation in the literature is that choice overload is a problem for those who are knowledgeable.

36. These biases are discussed in Deaves, *supra*, footnote 31, at section 4 and Andrew Lo, *supra*, footnote 32, and Andrew Lo, "The Adaptive Markets Hypothesis" (2004), *The J. of Portfolio Management* (30th Anniversary Issue) at pp. 15-29.

37. Reported in the *Globe and Mail Report on Business Supplement* for the Investment

The Deaves survey also found that disclosure of financial information was an important area for investors. Investors stated that they used mandatory disclosures and third party information but surprisingly they noted that the information that is being used is viewed as not being very useful. This information was not accessed electronically although retail investors said that they are open to this form of disclosure. A slim majority embraced a continuously updated disclosure document available online that consolidates relevant information. Finally, many of the investors purchased mutual funds and they desired clearer and greater disclosure of fees and returns.

As in all survey studies, great care should be used in interpreting what respondents say they will do especially under a scenario that is unfamiliar to them. For example, the use of electronic disclosure may be appealing to investors, but integrating it into their investment decision-making may be more difficult. Alternatively there may be no trouble in integrating this information if retail investors continue to ignore it possibly because they do not understand the contents of current documents.

Given bounded rationality and choice overload the Task Force makes the following recommendation: “The Task Force encourages securities regulators to work to make disclosure documents more effective by improving the method by which information is made available to investors to enhance the penetrability and comprehensibility of that information.” The Task Force discussed the trade-off of plain language disclosure documents, which would address the retail investor issue and moderate disclosure costs and the necessity of having full disclosure.

Regulators have moved in this direction currently in the mutual fund area with the release of a concept paper on disclosure of mutual fund information. The Joint Forum of Financial Market Regulators proposed a two-page document called “Fund Facts” that contained certain key information including the top ten investments held by the mutual fund, past performance, type of investor that is best suited to the investment, and advisor cost. The document is to be provided to investors either prior to or at the time of the sale of the mutual fund.³⁸

The Task Force also addressed the issue of electronic delivery of documents and concluded that an “access equals delivery” model be implemented, as long as there is a free, publicly accessible full record of all legally mandated disclosure documents such as SEDAR. Under

Funds Institute of Canada. The study found that approximately 80% of mutual fund holders used advisors in their financial decisions.

38. Joint Forum of Financial Market Regulators, “Proposed Framework 81-406: Point of sale disclosure for mutual and segregated funds” (June 15, 2007).

this model an investor cannot request documents in non-electronic format. If information in this form is needed, it can be accessed from the wealth adviser. The recommendation is as follows:

The Task Force recommends: (i) that all requirements for the delivery of disclosure documents be abolished and, instead, that all disclosure documents be required to be filed on SEDAR and on the issuer's website, and (ii) the elimination of any requirement to "deliver" a document would render investor consent to "access equals delivery" unnecessary.³⁹

Investor education/financial literacy has and continues to be an important issue given the observed financial abilities of retail investors. There are many initiatives in this area. For example The Council for Investor Education is a forum of not-for-profit organizations and regulators interested in empowering Canadians with the knowledge to make informed financial decisions. The members include provincial security regulators and self-regulatory organizations, among others. These organizations recognize that investor education is crucial to effective investment decision-making — there is a set of information that investors must have: time value of money, importance of diversification and asset allocation, and the impact of fees on performance. However, attempts to provide investor education have been at best modestly successful. Further if behaviour is "hard wired" and investor education is intended to reduce some problems, many decisions made, not only by retail but also by sophisticated investors, will continue to be irrational.

The Task Force has three recommendations related to financial literacy.⁴⁰ They are as follows:

- financial literacy must be treated as a matter of national priority;
- create a national coordinator of public and private sector investor education initiatives; and
- undertake further study by capital market stakeholders to design programmes that ensure that the objective of financial literacy as a national priority is achieved.

39. The Task Force also recommended that securities regulators encourage and facilitate the use of XBRL, information layering and interactivity within electronic disclosure documents. The Task Force proposed a model called MERIT (Model for Effective Regulatory Information Transfer) that uses XBRL and demonstrates how information disclosure can be improved and be as informative as the investor's knowledge requires.

40. The Task Force is not alone in the push to financial literacy. In the United Kingdom, the FSA introduced an education campaign in 2006; the U.S. Treasury launched its National Strategy for Financial Literacy in Autumn 2006; in November 2006, the Dutch Ministry of Finance established CentIQ.

There is, however, a concern about financial literacy. Williams notes that financial literacy can be of two types: the first is to empower investors within existing consumer protection laws; this approach is intended to reduce barriers to participation and improve access to information. The second type is to shift responsibility of personal economic security from the state to the individual resulting in individuals becoming accountable for market governance. Williams argues that this approach is a result of market expansion and the introduction of new investment products.⁴¹

Williams investigates why regulators deploy financial literacy education. Looking at the FSA and the Financial Consumer Agency of Canada investor education mandates, she “cautions against uncritical acceptance of claims that financial literacy education empowers consumers and advances their interests.” Williams argues that in a setting of increased volatility of markets and an increase in the supply of new products, “the empowerment discourse of financial education may mask a more complicated regulatory project in which education of the consumer serves also to protect regulators and financial firms.”⁴² Although based on a sample of two regulators, the paper presents an issue that should be considered in the development of financial literacy programs.

A crucial question that was not considered by the Task Force is whether investor education can improve investment decisions. The extent of the impact of behavioural biases on investment decisions has been investigated in some depth in the finance literature. The increased importance of defined contribution plans has provided some further evidence of the extent of behavioural biases. Even though corporations have provided financial education to members of their plans, employee irrational behaviour continues in their DC plan investments. Research shows that members default on their payments, do not make effective asset allocation decisions, do not rebalance portfolios and do not contribute the maximum amount even though employers will match their investment.

Recognizing the severity of these problems the United States enacted the Pension Protection Act (PPA) in 2006,⁴³ the purpose of which was to provide a safety net for pension fund members who cannot make their own decisions. The PPA permits employers to automatically enroll members and bump up contribution levels on an

41. Toni Williams, “Empowerment of Whom and for What? Financial Literacy Education and the New Regulation of Consumer Financial Services” (2007), 29 *Law & Pol’y* 226.

42. *Ibid.*, at p. 248.

43. Pub. L. No. 109—280, 120 Stat. 780.

ongoing basis. Also it provides a “safe harbour” against future legal actions by plan members who believe that their retirement income is inadequate provided that the employer/sponsor acts prudently and within the PPA guidelines. DC plan sponsors have introduced automatic enrollment, automatic escalation of contribution amounts in default or active funds with asset allocation related to date of retirement. A survey in 2006 of 50 large DC plans found that 24 had already implemented automatic enrollment and two were considering it within the coming year. Also 14 had automatic contribution increase policies. Unfortunately, many plan participants simply accept plan defaults set by the company sponsors — this is the path of least resistance. This passive choice can be explained by predicted behavioural tendencies.

Can education overcome the behavioural problems and lead to better decision-making by investors? Financial education attempts by companies for their employees provide some indication of the success. One study⁴⁴ investigates financial seminars offered at 40 locations collectively employing one third of the company’s workers. The seminars were given by an outside firm specializing in these services. Overall, approximately 17% of eligible workers attended the seminars and while many reported intentions to make changes, few actually did so.

In a related study⁴⁵ the authors found that of non-plan participants who attended the seminar, 100% planned to enroll while 14% actually did over a subsequent six-month period; interestingly 7% of non-attendees also made the change so the financial education seminar seemed to have some impact. For actual plan participants, those who attended planned to make changes in fund selection and fund allocation along with increased contribution rates. Approximately one-third of those who said they intended to make a change actually did so and the absolute number of those who changed was just slightly larger than those who did not attend the seminar. In another paper,⁴⁶ a follow-on survey undertaken

44. Brigitte Madrian and Dennis Shea, “The Power of Suggestion: Inertia in 401(k) Participation and Savings Behaviour” (2001), 116 *The Quarterly Journal of Economics* 1149 at pp. 1149-187.

45. James Choi, David Laibson, Brigitte Madrian and Andrew Metrick, “Saving for Retirement on the Path of Least Resistance”, in Ed McCaffrey and Joel Slemrod, eds., *Behavioral Public Finance: Toward a New Agenda* (New York, NY, Russell Sage Foundation, 2006) at pp. 304-51. The financial seminars were held from January to June 2000 and the actual changes in behaviours over the period December 31, 1999 through June 30, 2000.

46. Robert Clark, Madeleine d’Ambrosio, Ann McDermed and Kshama Sawant, “Retirement and Saving Decisions: the Role of Information and Education” (2006), 5 *Journal of Pension Economics and Finance* 45 at pp. 45-67.

subsequent to attending financial education seminars asked whether the individuals had actually altered their savings behaviour. The authors found that of the 41% who reported they intended to establish a supplemental savings plan in a previous survey, 25% actually did so. Of the 31% who intended to increase contributions to an existing plan, 42% reported that they had done so. Of the 37% that reported they would increase contributions to an existing plan, 42% reported in the follow up survey that they had done this.

This literature suggests that retirement (financial) education, while having significant resources dedicated to it, seems not to have had a major impact on behaviour. In fact, in the pension area, behavioural finance has been used to develop strategies to improve decision-making by pensioners in order to improve their wealth level at retirement.⁴⁷ These strategies do not focus on financial literacy!

While the literature noted above concentrates on defined contribution employee pension plans, similar financial literacy issues arise in investments outside of the employee pension area. Thus given behavioural tendencies operate to blunt the impact of education, there is some question as to whether this should be a major thrust.

We do not suggest that financial literacy/investor education attempts be eliminated. However, there are a number of questions that need to be addressed before a program is developed and implemented. These include the following: what is the purpose of the program — is it to empower investors within existing consumer protection laws or to make investors responsible to influence financial markets through market governance? At what level do you start the process — is it high school or later in life when individuals have to make investment decisions? What topics should be included in the program given the level chosen?

Since most investors in the Deaves survey invested through mutual funds, it is essential that they understand the importance of fees in their ultimate wealth and the concepts of asset allocation and diversification. While some retail investors do their own investing, it is usually done with the help of an investment advisor. Education on how to evaluate an advisor and what to expect from them is also crucial.

Finally, behavioural finance can be used to think about relevant education for individual investors. Also, investment products can be developed that minimize the impact of behavioural biases. An

47. Peter Kooreman and Henriette Prast, "What Does Behavioral Economics Mean for Policy? Challenges to Savings and Health Policies in the Netherlands" (paper presented to the Netspar Panel, April 26, 2007) [unpublished].

example is a mutual fund that automatically changes asset allocation as the investor ages.

V. CONCENTRATED OWNERSHIP: PYRAMIDS, DUAL CLASS AND DIRECT OWNERSHIP

An important factor in the Task Force mandate was to make recommendations to maintain and in fact improve Canadian capital-market competitiveness. The Task Force commissioned a number of research papers in this area of interest and in many instances the research was reflected directly in the Report and the recommendations. There were two research papers that did not lead to recommendations. The first paper identified a problem in the venture-capital market, which required firms to go public too early and thereby incur both indirect and direct costs.⁴⁸ Although not stated explicitly in the Report, this area was likely not considered in the recommendations since the problem was primarily one of the venture-capital market and not the publicly traded equity market. The second paper considered the impact of the divergence of voting and cash-flow rights generated by pyramid structures and voting structures in which there were classes of shares with differential voting rights. This paper entitled "Some Obstacles to Good Corporate Governance in Canada and How to Overcome Them" provided an excellent summary of the literature in this area. The authors make the following statement concerning the state of Canadian capital markets:

Canadian regulators, lawmakers and good governance advocates alike look towards the United States and United Kingdom for ideas. This is sensible in many realms of law because those countries, like Canada have Common Law legal systems and rely heavily on stock markets to assemble and allocate capital. Unfortunately, the structure of governance in much of corporate Canada is radically different from that in either the United States of the United Kingdom, and more closely resembles that in Latin America, parts of Europe and East Asia.⁴⁹

Dual class shares and pyramid structures have been a major constituent of Canadian capital markets for many years. For the former, there are three types of restricted voting shares;⁵⁰ in some

48. Douglas Cumming, "Do Companies Go Public too Early in Canada", The Report, *supra*, footnote 1, at p. 215 (volume 4).

49. R. Morck and B. Yeung (2006) "Some Obstacles to Good Corporate Governance in Canada and How to Overcome Them", The Report, *supra*, footnote 1, at p. 286 (volume 4) (Morck and Yeung).

50. Non-voting shares have no votes; subordinated voting shares have one vote per share while the other class has multiple votes per share; restricted voting shares

cases the superior voting shares are not listed on the stock exchange. The most frequent method of generating a dual-class share structure is through an IPO; next in popularity is a split of the existing single-share class. Subsequent to the IPO the company would issue more restricted voting shares relative to superior voting shares thus leveraging the voting power of the control group. Dual class recapitalizations are generally observed in companies in which there is a combination of a large controlling shareholder with family interests as opposed to concentrated ownership on its own. While there has been a reduction in the number of dual-class share companies over the period 1989 to 1998, their number is still large and they represent substantial amount of assets in the capital market.

Pyramid structures generally have an ultimate owner, usually a family, at the apex of a control pyramid with multiple layers where multiple class shares, cross holdings and appointment of family members and friends in top executive positions establish control and increase the firm's opacity. Attig presents data showing that 53.45% of Canadian firms are controlled by a pyramid structure in which there are on average 3.56 tiers. This percentage is much higher than found in both the U.S. and U.K. capital markets. Interestingly, family control was found in 63% of these firms and family management in 70%.⁵¹

The theory associated with the problems of dual class and pyramid share structures is straightforward and well known. Under a one share, one vote regime, agency costs arise when ownership and control diverge such as when management has a small ownership percentage. Any agency costs that could arise are managed not only through governance but also through the takeover market. Research has also shown that agency costs can exist as well at high levels of control due to entrenchment of management.⁵² There is a rich literature investigating the private benefits of control.⁵³ Where dual class or pyramid structures exist, cash flow rights and voting rights diverge, thereby introducing two types of agency costs: the first is entrenchment, since a set of shareholders has the voting rights;⁵⁴ the

have a vote equal to the vote on the other class but can only elect a minority of the board of directors. As of 1998, 148 companies listed on the tsx had a dual class share structure; 35% had non-voting shares, 56%, subordinated voting shares and 5% restricted voting shares. See B. Amoako-Adu and B. Smith, "Dual Class Firms: Capitalization, ownership structure and recapitalization back into single class" (2001), 25 J. of Banking and Finance 1083.

51. N. Attig, "Balance of Power" (2005), Canadian Investment Review 6.

52. P. Halpern, R. Kieschnick and W. Rotenberg, "On the Heterogeneity of Levered Going Private Transactions" (1999), 12 Review of Financial Studies 281.

53. See the discussion in Morck and Yeung, *supra*, footnote 49.

second is behaviour that shifts benefits to the controlling shareholders from restricted voting shareholders since the controlling shareholders have a small cash-flow rights position. This divergence between cash flow and voting rights can lead to control of a company with a small voting position. As of 1998 for all restricted voting shares, to hold 50% of the voting control required a minimum of 15% of the equity.⁵⁵

There are commentators who find dual-class share structures to be less serious than the majority of the literature. Allaire reviews the various arguments concerning dual-class shares and concludes that, as long as minority shareholders are well protected “this capital structure provides the advantages of continued, long-term commitment by the entrepreneur/founder and, in many cases, of his/her descendants.”⁵⁶ This paper recognizes concerns with dual-class shares and recommends the implementation of a proper framework to protect the rights and interests of minority shareholders. Examples include takeover bid provisions, capping voting ratios such that the entrepreneur must own at least 20% of the company’s voting capital in order to achieve 50% of the votes.

Why should the Task Force have been concerned about the impact of the divergence of voting and cash flow rights through the use of dual class and pyramid structures? Morck and Yeung,⁵⁷ provide a number of concerns that come from their review of the literature.

- “Control blocks in large Canadian firms are more substantial than in any other Common Law country. Further, Canadian controlling shareholders make more extensive use of pyramiding and/or super-voting shares, for their control rights exceed their actual share ownership by a greater margin than in other Common Law countries.”⁵⁸
- There is a Canada discount such that holding all relevant influences constant, Canadian stocks are valued by about 9.3% on average over the period 1991 to 2000. While there

54. V. Jog, P. Chu and S. Dutta, “One Share-One Vote” (Fall 2006) Canadian Investment Review (showing that dual-class share companies are subject to takeover activity but clearly this activity must be to the benefit of the controlling shareholder. The authors note that over the period 1993 to 2004 there were 143 firms with dual-class shares delisted, of which 50% were acquired, merged or privatized).

55. See B. Amoako-Ado and B. Smith, *supra*, footnote 50, at p. 1088 (table 1).

56. Y. Allaire, “Dual-class share structures in Canada: Some modest proposals” [unpublished, archived at SSRN], online: (IGOPP) Working Paper Series, <<http://ssrn.com/abstract=952043>>.

57. *Supra*, footnote 49.

58. *Ibid.*, at p. 313.

may be a number of explanations, one possible one is “Canadian controlling shareholders siphon off private benefits.”⁵⁹

- If insiders take large private benefits of control, less remains for public shareholders and the size and activity of the country’s stock market will be negatively affected without offsetting regulatory action. The empirical evidence “shows that Canada has smaller and less active stock markets than would be expected in a Common Law country of its size. Relatively small, relatively sleepy stock markets are a likely symptom of a national corporate governance deficit.”⁶⁰
- “Canada entrusts the corporate governance of much of its large corporate sector to entrenched, politically influential, old money families. Morck *et al.*⁶¹ present evidence that this saps its economic performance. They refer to this condition as ‘the Canadian disease’, and suggest it weakens many developed and developing economies.”⁶²

Morck and Yeung conclude “evidence suggests that private benefits of control in Canada are larger than in other high income Common Law countries . . . Large private benefits of control undermine the good that might otherwise come from the presence of large blockholders.”⁶³ Throughout the Morck *et al.* paper there are references to the negative impact on value of dual-class shares. Some new research sheds additional light on the market impact of pyramid and dual-class structures and provides avenues of continued research. Attig *et al.*⁶⁴ investigate the impact of concentrated holdings on stock liquidity and information asymmetry in the Canadian market. In their sample they classify firms as widely or closely held by using a 10% ultimate control cutoff (using a 20% cutoff did not affect the results). Less than 20% of the firms are widely held. Of the closely held companies, more than half of the companies have a single controlling shareholder and pyramids are the most

59. *Ibid.*, at p. 316.

60. *Ibid.*, at p. 318.

61. R. Morck, D. Strangeland and B. Yeung, “Inherited Wealth, Corporate Control, and Economic Growth: The Canadian Disease” in R. Morck, ed., *Concentrated Corporate Ownership*, National Bureau of Economic Research Conference Volume (Chicago, University of Chicago Press, 2000), p. 322 (Morck *et al.*).

62. Morck and Yeung, *supra*, footnote 49.

63. *Ibid.*

64. N. Attig, W-M. Fong, Y. Gadhoun and L. Lang, “Effects of Large Shareholding on Information Asymmetry and Stock Liquidity” (2006), 30 *J. of Banking & Finance* 2875.

frequently used channel for which voting and cash-flow rights diverge. Attig finds that closely held firms with significant ultimate ownership have a wider bid-ask spread (lower liquidity) than widely held firms but there was no evidence that information asymmetry was more severe in closely held than in widely held firms *as long as ultimate control does not exceed ultimate ownership*. If ultimate ownership is held constant and ultimate control increases by the use of either pyramids or dual-class shares, the stock is subject to more serious information asymmetries and the bid-ask spread widens. These results are consistent with the hypothesis that firms that have control in excess of ownership manage disclosure of information in an attempt to generate private benefits.⁶⁵ Other research has shown that value is increasing in cash flow rights and not in voting rights in considering dual class and pyramid share structures.⁶⁶ Attig in another paper finds that earnings management is more serious in pyramid structures; the use of multiple class shares is only significant when combined with the presence of family control.⁶⁷ New research is now being undertaken to look at accounting disclosures in dual class and pyramid structures.

Li *et al.*,⁶⁸ in a recent working paper, investigate institutional holdings in dual and single-class shares. Using a sample of U.S. dual-class shares and adjusting for determinants of institutional investment, they find that institutional investors own a significantly lower proportion of the equity in dual-class firms compared to their percentage holding in single-class firms. Further they find that long-term investors with strong fiduciary duties, such as insurance companies and pension funds, more strongly avoid dual-class shares than do short-term investors with weaker fiduciary duties such as investment companies and independent investment advisors. After a unification of the dual-class structure, institutions increase

65. These results are consistent with those observed in J. Fan and T. Wong, "Corporate Ownership structure and the informativeness of accounting earnings in East Asia" (2002), 33 *J. of Accounting and Economics* 410

66. See P. Gompers, J. Ishii and A. Metrick, "Extreme Governance: An Analysis of Dual-Class Firms in the United States" (2006) Harvard Business School Working Paper (U.S. data) [unpublished, archived with authors]; and S. Claessens, S. Djankov, J. Fan and L. Lang, "Disentangling the Incentive and Entrenchment Effects of Large Shareholding" (2002), 57 *J. of Finance* 2741 at pp. 2741-772 (for Asian countries; also finding that the increase in firm value with cash-flow rights decreases when voting rights exceed the cash-flow rights).

67. N. Attig, *supra*, footnote 51.

68. K. Li, H. Oritz-Molina and S. Zhao, "Do Voting Rights Affect Institutional Investment Decisions? Evidence from Dual-Class Firms" *Financial Management* [forthcoming in 2008], online: Kai Li - W.M. Young Professor of Finance at Sauder School of Business UBC <http://finance.sauder.ubc.ca/~kaili/dual-class_FM.pdf>.

their holdings of the firm. Thus if liquidity is an issue, dual-class shares appear to reduce the demand of large investors.

A recent paper investigates the impact of cross listing companies in the U.S. on security prices.⁶⁹ The authors observe that cross-listed firms with a single class of shares have a permanent increase in valuation only if they attract and maintain investor recognition over time. Cross-listed firms with dual-class shares exhibit a permanent increase in valuation regardless of the level of U.S. investor holdings. The authors conclude that this increase in valuation for dual-class firms suggests that “cross-listing lowers the risk of expropriation of minority shareholders.”

Given the empirical evidence of lowered market values and reduced liquidity for pyramids and dual-class shares, the obvious question is why have there not been significant numbers of either recapitalization into a single class (unification) in the case of dual-class shares or devolution of the pyramid through sell-offs, for example, in the case of pyramid structures. For dual-class shares there have been instances in which mergers or going private transactions eliminated the dual class. In some situations there have been unifications of the various equity classes, typically occurring through a share exchange using a different exchange ratio for each of the share classes into the new unified class. The decision to unify by the controlling family/owner will reflect the tradeoff of increasing value on the shares owned with a reduction in value through the private benefits of control. Clearly, the greater the difference between control and cash-flow rights, the less likely is a voluntary unification unless there is a favourable exchange ratio. Over the period 1979 to 1998 there were 56 cases of unifications through share exchange. The reasons were varied and included the following: a condition of debt restructuring in the cases of financial distress; facilitation of sale of a control block; increase the appeal to institutional investors in the case of a seasoned issue or increase the appeal to investors prior to a seasoned issue and facilitate a listing in the United States.⁷⁰

VI. POLICY ISSUES

In the dual class situation investors vote on the introduction of the

69. M. King and D. Segal, “The Long-Term Effects of Cross-Listing, Investor Recognition, and Ownership Structure on Valuation” Review of Financial Studies [forthcoming in 2008].

70. See B. Amoako-Ado and B. Smith, *supra*, footnote 50 (also noting that in four situations the elimination of the dual-class structure was associated with the introduction of a shareholder rights plan).

restricted voting shares and given this fact, some commentators suggest that whatever the impact of these structures nothing needs to be done in the regulatory process. Unfortunately many of these structures were introduced during a period where there was a limit on the amount of foreign property that could be held in portfolios in order to maintain their tax deferred status. Thus investors had very little choice, apart from not purchasing these shares and thus reducing diversification benefits. Also, while the market seems to price restricted voting shares lower,⁷¹ there is some indication that investors, certainly in 2004, did not understand the status of the shares they purchased. In 2004 the TSX announced that it would introduce extensions to the ticker symbol to designate the voting power of the shares of companies with dual-class shares. Using a set of stocks that were subject to the re-symbolizing decision and that passed certain exclusion criteria, Attig⁷² investigated the impact on share price and liquidity around the date of the announcement. More than 80% of the involved firms were family controlled through pyramid holdings. He found that the rule to re-symbolize tickers had a negative and significant impact on the prices of lower voting and non-voting classes. Also there was a decrease in abnormal turnover of the stocks with the most severe decrease incurred by non-voting shares. Further, when measured by bid-ask spread, lower voting and non-voting shares had an increase in spreads whereas multiple voting shares had a reduction in the spread.⁷³ The results suggest that transparency is useful to investors but begs the question why investors did not incorporate the status of the voting control of stocks, which was available to them prior to the ticker change.

Finally, from a policy perspective there are many governance issues which investors would incorporate in the security price absent securities regulation. However, regulation has been introduced to address these problems and dual-class shares and pyramids, according to Morck and Yeung, should be no different.

This report presents a list of 12 recommendations that are designed to establish a governance regulatory structure in which there is a limitation on the scope of abuse by controlling shareholders who have magnified power through the use of dual class and pyramid

71. S. Smart, T. Ramabhadran, S. Thirumalai and C. Zutter, "What's in a Vote? The Short- and Long-Run Impact of Dual-Class Equity on IPO Firm Values" (2005) Working Paper, University of Pittsburgh online: <<http://ssrn.com/abstract=784722>>.

72. N. Attig, "Multiple Class Shares: The Information Content of Ticker Symbols" (2007) Working Paper, Saint Mary's University [unpublished].

73. Attig, *supra*, footnote 68, at p. 6 (suggesting that this result may be the result of "decreased likelihood of informed trading by holders of multiple voting shares").

capital structures. Their recommendations are intended to avoid banning dual class or pyramid structures since this would be difficult and any change would have to incorporate a wealth transfer to the controlling shareholders to compensate for the expropriation of their voting power. The first nine recommendations apply to both dual class and pyramid structures.

The tenth recommendation deals directly with the dual-class share structure and states that “dual class share structures should require periodic renewal by a majority of inferior voting shareholders.”⁷⁴ As long as the controlling shareholders are operating the firm efficiently they need not fear the vote since the firm value will not be negatively affected by the structure and the controlling shareholders’ plans are viewed to create value. This recommendation is less invasive than that introduced in Israel, in which there is a moratorium on new issues of superior or inferior voting shares. Thus Israeli firms that intend to raise new equity would have to unify their share structures.⁷⁵

Morck and Yeung have two recommendations regarding pyramid structures. The first is to eliminate the ability to increase control by purchasing small amounts of equity of various companies by requiring any shareholder who acquires 30% or more of a listed company to acquire 100%. This rule is found in the United Kingdom. While this recommendation may be controversial, the second recommendation goes even further. The recommendation is “[f]irms controlled by listed firms or via super voting shares should be excluded from stock market indexes used by Index Funds.”⁷⁶ The purpose is to reduce the size of the investor base and to have the index represent to outside investors that companies in the Canadian market have good governance.

Morck and Yeung recognize that their recommendations are not easy to implement and likely will be disliked by the principals of large business groups and the owners of superior voting shares, individuals who have influence in politics and commerce. However, they recommend their reforms so as to put Canada on par with governance as found in the United States and United Kingdom and thereby improve Canadian capital markets.

74. *Supra*, footnote 49, at p. 338.

75. See S. Hauser and B. Lauterback, “The Value of Voting Rights to Majority Shareholders: Evidence from Dual Class Stock Unifications” (2004), 17 *The Review of Financial Studies* at pp. 1167-184 (noting that unifications raised shareholder value, especially in family-controlled firms).

76. *Supra*, footnote 49, at p. 340.

VII. CONCLUSION

The Report provided a great deal of insight regarding the path that Canada's road to modernize its securities legislation might take. Much of its strength lay in its breadth of vision as well as in the incredibly strong foundation of excellent research conducted by researchers from around the world. This article has focused on certain key topics that would be relevant to the increasingly important retail investor. Those four key topics were enforcement, rules vs. principles, financial literacy and disclosure, and dual class/pyramid share structures.

With respect to enforcement of securities laws, the Task Force was concerned about the "Canadian Discount" mentioned earlier and the effect that the perception of Canadian enforcement may have had in contributing to this. Research studies conducted by Bhattacharya confirmed that countries with stricter enforcement of securities laws have a lower cost of capital. The empirical study conducted by Howell Jackson suggests that U.S. and Canadian funding and staffing levels for securities enforcement may not be vastly different when adjusted for economy and other variables. The Cory and Pilkington Paper made many useful recommendations aimed at consolidating securities regulation enforcement into an efficient, fair and just process. These recommendations included expanding the scope and power of IMET as well as harmonizing and coordinating enforcement efforts across various jurisdictions.

One critical point to note is that retail investors often lack the financial resources or even the knowledge to access enforcement as a form of either protection or compensation. The individual retail investor, for example the investor who manages his/her own retirement fund, is one particularly vulnerable category of person upon whom the law and enforcement authorities should focus. While the Task Force focused on making disclosure accessible to retail investors, there was little mention of how enforcement efforts might directly address the needs of retail investors. For now, the recommendations that enforcement authorities be encouraged to bring compensatory claims on behalf of aggrieved investors is a potentially promising first step towards empowering an accessible regime of private enforcement in tandem with public enforcement.

Although the topic of rules versus principles may seem at a theoretical level, distanced from the everyday lives of retail investors, the practical outcomes of this debate may have some significance nevertheless to the retail investment sector. The approach adopted by regulatory authorities can be expected to have some impact on

enforcement activities and correspondingly may affect retail investors through its overall structure. At a broad level, the distinction between rules and principles is a theoretical one that nevertheless has many practical consequences. Research from the Task Force emphasized that most laws lay somewhere in the middle of a spectrum between detailed and specific rules on the one hand and general abstract principles on the other hand. Cunningham's research revealed that public enforcers seemed to prefer rules-based enforcement slightly while private professional body enforcers seemed to heavily prefer principle-based enforcement. While there is the perception that U.S. securities enforcement is rules-based while Canadian securities enforcement is principles-based, the evidence gathered by his research did support this assertion. These findings suggest that the interplay between rules and principles is likely to be a highly dynamic and complex one that does not lend itself well to transplantation from other jurisdictions. Canada's path towards securities regulation reform, whether it is through greater harmonization or through a common securities regulator or even a common enforcement body, may point towards a role for detailed rules, though broad over-arching principles will still be required to help in the interpretation of those rules. Similarly, rules-based laws may be required for more serious transgressions under criminal law. The extent to which rules and principles lay out a comprehensible scheme of securities laws will be important to the retail investor. An efficient system of enforcement is required for retail investor protection and clearly comprehensible rules with principles that are easily grasped by laypersons may prove to be an important factor in the promotion and protection of the retail investor market.

The Task Force's analysis of the complex world of how retailer investors make decisions is one that should be carefully heeded. The empirical research conducted by Deaves sheds some very useful insight into the world of the retail investor and brings it down to a very practical level of how decisions are actually made, as opposed to the perfectly rational, efficient markets paradigms that are often posited. In the Deaves study, there was confirmation that retail investors suffer from many behavioural biases and often make incorrect decisions relating to diversification and asset allocation. This led the Task Force to make key recommendations including improved disclosure that balances plain language versus the cost and necessity of full disclosure. Furthermore, it was recognized that the improvement of financial literacy is relevant for Canadians although there is evidence that increasing financial literacy may not have as great an impact or benefit for retail investors as one might

have thought. This is not to suggest that financial literacy education be eliminated, only that it be focused at the appropriate base levels first in a nationally coordinated scheme.

Morck and Yeung provide evidence from the academic literature that dual class and pyramid share structures have negative consequences for the economy and for capital markets. While closely held shares have an entrenchment impact, it is the increasing divergence between control rights and cash flow rights in dual class and pyramid structures that generate the most concern. Further, ongoing research in both Canada and the United States suggests that these structures impact share liquidity, transparency of reporting, earnings management and holdings by some institutional investors. Fundamental change to remove dual-class shares or to eliminate pyramids would be very difficult given the importance, either economic or political, of these companies and families who control them. Thus Morck and Yeung take a different route and make recommendations intended to improve the governance of these companies so as to reduce the economic impact and to provide a better picture to foreign investors about Canadian capital markets. Some of the recommendations are controversial and may go beyond the boundaries of securities regulation.

Following the release of *The Report*, a few notable events have taken place that should have an impact on the position and well-being of the retail investor, directly and indirectly. The Ministry of Finance released a document entitled "Advantage Canada," which emphasized the role and importance of the capital markets in enhancing the competitiveness of the Canadian economy. Nick Le Pan was appointed a special advisor to review the structure and governance of IMET. While not an issue that was within the direct mandate of the Task Force, it is important to note that the Federal Minister of Finance has also announced that he will be appointing a special panel to review the structure of securities regulation in Canada. In particular, the Task Force will be comparing the passport model to a common regulator. The debate on a national or common regulator has been going on for decades, but if we can address the issues associated with provincial disempowerment in a reasonable way, there may be a chance to turn the discussion into reality, for the benefit of Canadian investors and issuers. There may be an opportunity here to turn our Canadian discount into a Canadian premium. All of these initiatives hold the promise of benefiting the retail investor.