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## 'Canada Steps Up' - Task Force to Modernize Securities Legislation in Canada: Recommendations and Discussions

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# ‘Canada Steps Up’—Task Force to Modernize Securities Legislation in Canada: recommendations and discussion

Paul Halpern and Poonam Puri\*

## Key points

- The Task Force to Modernize Securities Legislation in Canada released its report entitled ‘Canada Steps Up’ in October 2006. Its 65 recommendations focused on bringing Canadian securities law into the 21st century, enhancing Canada’s competitiveness in the global marketplace and eliminating its higher cost of capital relative to the US.
- This article reviews and analyses the Task Force’s recommendations in five critical areas: cost – benefit analysis (CBA), improving access to capital markets, the use from electronic disclosure systems and financial literacy, the regulation of hedge funds and finally, enforcement.
- This article also reviews two issues that received significant Task Force discussion, but were left as ideas for consideration, namely an insurance scheme for misinformation in the capital markets and subsidizing securities analysis to improve analyst coverage of small firms.
- Finally, conclusions are drawn from the Task Force’s deliberations and recommendations and next steps are suggested.

## 1. Introduction

There is a Canadian discount in the cost of equity capital. One study observed that the cost of equity capital in Canada is 25 basis points higher than in the US<sup>1</sup> and a second noted that valuations of Canadian public companies are significantly lower than those found in the US.<sup>2</sup> There are a number of possible explanations of this latter observation: first, there are many companies in the Canadian capital market that have either dual class or pyramid share structures; these structures can lead to problems from the divergence of ownership and control<sup>3</sup>; second, there may be a perception (or even reality) that enforcement of securities legislation is less vigorous in Canada than that found in the US. Whatever the explanation, attempts to, at a minimum, remove this discount are important to improving Canadian economic growth.

Competitive capital markets are crucial to an economy. From an issuer's perspective, they facilitate raising capital from domestic and increasing numbers of international investors at reasonable cost thereby enhancing business operations and generating employment. If the Canadian capital market is viewed as a good venue to raise funds, new companies will issue, sophisticated investors will enter the market and securities prices will reflect better the underlying value of issuers' equity (referred to as an improvement in price discovery). Liquidity will also increase. Both domestic issuers and investors will be better off. However, if investors believe that the capital market is open to manipulation, that there is false or incomplete information, that corporate governance is not effective and/or they are not being treated fairly, investors will either leave the market or if they stay, they will reduce the price (increase the cost of equity) of securities to protect against this behaviour. Both outcomes will have a negative impact on the economy. As cost of equity capital increases, corporate investment and economic activity decreases. For individual and institutional investors, competitive capital markets facilitate the construction of portfolios of diversified securities for specific purposes, such as retirement.

Recognizing the importance of capital markets and the need to keep them current, the Investment Dealers Association of Canada ( 'IDA' ) in June 2005 commissioned the Task Force to Modernize Securities Legislation in Canada (the 'Task Force' ). The mandate of the Task Force under the Chairmanship of Thomas Allen was to make recommendations to modernize securities legislation in Canada that would maintain or enhance the competitiveness of Canada's capital markets while continuing to protect individual investors.

The first challenge facing the Task Force was to focus the scope of the analysis since the possible areas in which changes could be contemplated were wider than the securities area—for example, the role of taxation is crucial. The Task Force limited its investigation in a number of dimensions. First, it decided not to duplicate reviews undertaken by provincial securities regulators. Second, it limited consideration of the role of self-regulatory organizations (SROs) to the enforcement area. Third, although a crucial element, it decided that analysis of the regulatory fragmentation in Canada and the issue of the national regulator or its alternative, the passport system, would not be part of its analysis.

Fundamental to its deliberations was the recognition of the trade-off between the needs of issuers and the importance of protecting retail investors. At one extreme, issuers would prefer a situation in which the market was permitted to provide regulatory control. However, as academic research has demonstrated,<sup>4</sup> there are situation in markets, especially in the those dependent on information, in which markets can fail. At the other extreme, investor protection can be achieved by tight regulation and extensive disclosure. However, this comes at a cost in terms of added regulatory costs to issuers and constraints on innovation in securities markets. This trade-off has been recognized in the analysis undertaken by the Task Force and in its recommendations.

The Task Force engaged the Capital Markets Institute (CMI) at the Rotman School of Management, University of Toronto to act as Research Director. With CMI involvement, the Task Force commissioned 30 research papers by leading Canadian and international academics and legal practitioners to elicit the most current thinking in securities

regulation and to test whether a number of potential recommendations were worth pursuing. More than 40 researchers were engaged in this endeavour and the resulting set of research papers is unprecedented in a Canadian study of capital markets. The Task Force also obtained written and oral submissions from stakeholders and other interested parties. The result of this activity is a set of 65 recommendations in a number of areas. The Report was released in October 2006.

This article is organized as follows: In Section 2, we consider five of the major areas in which the Task Force recommendations are found. These include recommendations concerning cost – benefit analysis (CBA), improving access to capital markets, the use of electronic disclosure systems and financial literacy, the regulation of hedge funds and finally, enforcement. In Section 3, we review two issues that received significant discussion but were left for further study as ideas for consideration. The first concerns the role of gatekeepers, in particular securities analysts. The discussion of this issue reflected, among other influences, reduced analyst coverage in general and for small firms in particular. The second is insurance for misinformation which is a mechanism to reduce investor risk with respect to misinformation in disclosure. In Section 4, we draw conclusions from the Task Force’s deliberations and recommendations.

We have not referred in any depth to the specific research studies that were commissioned by the Task Force. These studies along with the Task Force Report can be found on the Task Force and the IDA websites.<sup>5</sup> We have provided the recommendations in the Appendix to this article.

## 2. Recommendations and discussion

### Cost–Benefit Analysis (Chapter 3 in the Task Force Report<sup>6</sup>)

Market forces in a competitive market generally promote behaviours and conditions that benefit the market and penalize behaviours that harm the market. It is the role of the regulator to step in where market forces do not function perfectly and put the market's integrity at risk. The Task Force's view was that market forces work best when unencumbered, so regulatory intervention should be limited to the least degree necessary to solve a market problem. There is little that securities regulators can do in a proactive sense to foster competitiveness in the capital markets, but if regulators are not careful, there is much that can be done to hinder it. Therefore, the Task Force argued that regulators successfully enhance competition by staying out of the way as much as possible

However, there are situations in which regulation is needed either proactively or reactively. The policy rationale for intervention in capital markets has always been to improve the economic functioning of the markets in situations when markets either have not been doing or cannot be expected to do the job properly. This situation is referred to as market failure. The Task Force accepted this position but with its emphasis on letting the market work when appropriate, it recommended that anticipatory regulation be revisited regularly to determine if market forces continue to be unable to address the market failure. Further, a concern with an ever deeper intervention led to the recommendation that before any new rules were enacted, regulators

should assess whether stricter enforcement of existing rules would address the market failure. To do this effectively requires the regulator to identify the failure, the outcome the rule is intended to achieve and measurements to assess if the objective has been achieved.

The Task Force was also concerned that the introduction of significant new regulatory rules be assessed in a disciplined manner to determine if there is a market failure, and if the proposed rule will achieve the result in an economically efficient manner. The tool recommended for use by all Canadian securities regulators is cost-benefit analysis (CBA). In CBA, the dollar incremental costs and benefits of a rule are assessed and a new (old) rule is accepted (removed) when the benefits exceed (are less than) the costs.

The research paper on CBA reviewed the application of this approach in a number of jurisdictions in Canada, in the US and in the UK. Also, some specific examples were evaluated. Further the paper discussed a number of conceptual and implementation issues.

The Task Force endorsed the use of CBA and added a number of interesting augmentations:

- To the extent possible, a uniform set of published guidelines should be established outlining the methodology to be used in CBA.
- All CBA should include a clear description of the uncertainties (ie the predictions, assumptions, forecasts, etc.) that are associated with the analysis.
- Third-parties affected by a proposed rule should be encouraged to undertake their own CBA for consideration by securities regulators.

- Where a rule is adopted despite evidence that the expected benefits of a new rule are less than the expected costs, the securities regulators should be required to explain why they have adopted the rule. Moreover, there should be a mandatory re-evaluation of any such rule after a set period of time to ensure that the objectives of the rule are still being met.

The Task Force had two further points about CBA in terms of improving its implementation. The first is an *ex post* CBA conducted by a body independent of the group that introduced the regulation. Periodic reviews would be mandatory and could be conducted in conjunction with periodic review committees.

The second is a far reaching recommendation. The Task Force recommended the establishment of an independent body with the specific purpose of conducting, at defined intervals, a systematic CBA of every significant regulatory intervention into capital market activity. The independent body would be staffed by capital markets experts from all stakeholder groups. Where the CBA indicated that regulatory intervention was not justified, the securities commission would be entitled to preserve the regulation, but only by providing an explanation to the public for its disagreement with the independent body. The importance of assessing in a disciplined way the introduction of new rules is not limited to the Task Force recommendation. In November 2006, the Committee on Capital Markets Regulation, an independent group analysing the competitiveness of US capital markets made the following recommendation: ‘The SEC and SROs should move to a more risk-based regulatory process, emphasizing the costs and benefits of new rules. In weighing the costs and benefits of new rules, regulators should rely on empirical evidence to the extent possible.’<sup>7</sup>

## Improving access to capital markets



A key driver in the competitiveness of Canada's capital markets is the speed with which issuers are able to access capital. As ease of access to the capital markets increases, the number of participants—both issuers and investors—should also increase. Issuers will be drawn to a market in which capital can be accessed efficiently and, in turn, investors will be drawn with them. Further, access to capital markets should at least be as expeditious as found in competing capital markets such as the US.

A goal of Canadian capital markets regulation should be to ensure that, to the extent consistent with investor protection, the Canadian capital markets can be accessed with speed and efficiency that is comparable to, or greater than, other major markets. The recommendations in this section relate to 'follow-on' prospectus offerings and prospectus exempt offerings (ie private placements) by issuers that have already 'gone public' through initial public offerings. The speed issue centres on the extent to which a securities system should be based on required disclosure and *ex post* enforcement, or conversely, to what extent regulators must intervene on an *ex ante* basis through disclosure review.

### **The current Canadian regime: POP and shelf offerings**

The importance of quick access to the capital markets has long been recognized by Canadian securities regulators. Canadian issuers currently have two methods available to execute an expedited public follow-on offering of securities: (i) they can proceed by filing a short-form prospectus under the Prompt Offering Qualification System ( 'POP system' ) of National Instrument 44-101—*Short Form Prospectus Distributions* ( 'NI 44-101' ); and (ii) they can file a shelf prospectus and related prospectus supplement when they decide

to come to market under National Instrument 44-102—*Shelf Distributions* ( ‘NI 44-102’ ).

### *The POP system*

Under the POP system issuers file a short form prospectus that would make up for its brevity by incorporating by reference other disclosure documents, such as an annual information form, financial statements and material change reports. The key advantage of a short form prospectus is that the relatively short preparation time coupled with the abbreviated period for regulatory review permits an issuer to complete a distribution of securities in a relatively short timeframe (ie approximately three weeks from inception to closing). Less management time is required in preparing the prospectus document, and the regulatory review process is substantially shorter than in connection with a traditional long-form prospectus. A significant consequence of the POP system’ s introduction was the willingness of the underwriters to offer to issuers a product called a ‘Bought Deal’ , under which the underwriters, committed to purchase for resale the securities being issued, took the risk that, barring extraordinary events, the market might deteriorate between the date of the underwriting agreement and the date of closing. This risk was acceptable to the underwriter community because the period of exposure to the ‘market risk’ was substantially reduced. The ability to offer such a product to issuers in Canada has been a significant competitive advantage for the Canadian underwriting community and has undoubtedly been a positive factor to enhance the competitiveness of Canada’ s capital markets.

### *Shelf prospectuses*

An issuer that is qualified to file a short form prospectus in a jurisdiction is also qualified to file a base shelf prospectus in that jurisdiction. The shelf prospectus is an offering document prepared and filed in respect of an aggregate dollar amount of securities, which are then put on a metaphorical 'shelf' for up to 25 months until the issuer decides to take some or all of the qualified securities 'off the shelf' to distribute them. The securities regulators review base shelf prospectuses as they would review any other short form prospectus (typically within three working days of filing).

At the time of the actual sale, the issuer prepares a shelf prospectus supplement, that is often relatively brief, containing only deal-specific information, and disclosure about securities being sold that was not available at the time the base shelf prospectus was prepared and receipted. The prospectus supplement is not subject to any regulatory review at the time of issuance. Typically a distribution under a shelf prospectus supplement can be completed in as little as five days.

### *The unallocated shelf*

While the basic shelf prospectus provides flexibility to issuers because the timing of the eventual offering is determined by market or business opportunities that arise within the 25 month shelf period, the unallocated shelf prospectus provides even greater options because it allows qualification of debt, equity and other securities without a specific allocation of the aggregate offering amount among the classes of securities being so qualified. It is only when an offering is actually made (and upon the preparation and filing of the prospectus supplement) that the type and amount of security to be offered is fixed. Certain limits are imposed, however, as the prospectus must stipulate the total

dollar value of the securities the issuer proposes to sell under the shelf prospectus, which value is to be based upon the amount the issuer reasonably expects to sell within the 25 month period following the filing.

## **The US Public Offering Reforms**

In July 2005, the US Securities and Exchange Commission (the 'SEC' ) released a wide-ranging set of rules that will have a profound effect on the public offering process in the US<sup>8</sup> (the 'US Public Offering Reforms' ). Most of the rules are deregulatory in nature and while the reforms affect all registered offerings in the US, the most liberalizing aspects are available to large issuers with a reporting history. Among other things, the US Public Offering Reforms create a new class of issuer called a 'well-known seasoned issuer' ( 'WKSI' ), modify the offering communication rules around the time of registered offerings and permit the use of 'free writing prospectuses' and, in some cases, eliminate the need to physically deliver a final prospectus. Most notably, WKSIs are permitted to access the US capital markets without SEC review of their registration statements. Based on the criteria established for WKSI status, about 30 percent of the US listed issuers would meet the test for WKSI status.<sup>9</sup>

The liberalization of the registration rules and the speed to market afforded to WKSIs is predicated on the conclusion that within this category issuers are entitled to special treatment since they are most closely watched by the media, analyst community and institutional investors. If a company is big enough, has at least a year-long disclosure record and has a sufficient number of 'eyes' watching it on a constant basis, the SEC is

willing to permit its gatekeeping function (in the form of registration statement review) to be partially subsumed by the review undertaken by these other market participants. The Task Force was convinced of the appropriateness of this approach and investigated whether it could be introduced in the Canadian market

### **A Canadian Offering Reform Proposal**

Automatic shelf registration under the US Public Offering Reforms for those issuers in the WKSI category has allowed for nearly instantaneous access to the US capital markets for 30 percent of the US listed companies. In contrast, those Canadian issuers qualified to use the POP system (which, after amendments to NI 44-101 in late 2005, covers a vast majority of Canadian reporting issuers) and completing a 'bought deal' financing typically have at least three to five business days until they can confirm sales and begin collecting funds for closing. Admittedly, those using a shelf prospectus would have a shorter lag.

The Task Force was convinced of the need for Canadian firms to access the capital markets at a speed comparable to their counterparts in the US. After review of a study<sup>10</sup> undertaken to examine the background behind the SEC decision to undertake the WKSI route and an analysis of its applicability to Canada, the Task Force recommended that the WKSI concept from the US be introduced in Canada; it called the approach Canadian well-known seasoned issuers or C-WKSIs.

The C-WKSI framework encompasses three essential elements: (i) the criteria for an issuer to be eligible to use C-WKSI; (ii) the form of offering documentation and (iii) the speed advantage of being a C-WKSI. We consider briefly each of these elements.

### *C-WKSI eligibility criteria*

The underlying premise is that C-WKSI should receive less regulatory scrutiny because they are presumed to receive greater market scrutiny. To assess the Canadian eligibility threshold level, measured by market capitalization, the Task Force relied on a report by Adam Pritchard.<sup>11</sup> The US standard was quickly dismissed since it did not accord with the existence of more smaller capitalization companies in Canada, and thus the resulting set of C-WKSI eligible companies would not meet the Task Force goal of more rapid access to capital markets for as many issuers as possible.<sup>12</sup>

How low could the market capitalization cut-off be set without unduly risking a lack of attention by media, analysts and institutions to issuer disclosure? To determine the threshold level Pritchard looked at analyst coverage since this is a good proxy for market coverage. He found that analyst coverage ‘remains relatively robust—for those companies making offerings—down to the level of \$345 million in market capitalization’ . A \$350 million cut-off would place nearly 30 percent of TSX issuers in the C-WKSI category (using market capitalizations at the end of 2005). Moreover, only 12 issuers on the TSX-30 index would be excluded if this standard were imposed. The subsequent Table 1, which has been taken from Prof. Pritchard’ s study,<sup>13</sup> shows analyst coverage at various levels of market capitalization based on a sample of 10 randomly chosen companies at specified ranges of market capitalization.

### *C-WKSI offering documentation*

To facilitate speedy access to the capital markets, the Task Force recommended that C-

WKSI be allowed to offer securities to the public using a simple 'term sheet' that

Table 1. Analyst coverage

Market Capitalization (\$s in millions)	Mean number of analysts	Max/Min number of analysts	Number of issuers with no analysts
1,150 - 2,300	8.3	16/3	0
1,000 - 1,150	7.1	10/2	0
920 - 1,000	7.0	12/2	0
800 - 920	7.7	13/1	0
690 - 800	3.6	9/1	0
575 - 690	3.9	10/0	1
460 - 575	3.7	9/0	3
345 - 460	5.8	11/1	0
230 - 345	2.5	5/0	2
85 - 230	3.2	6/0	2
Overall	5.3	16/0	8

summarizes the material terms of the securities being offered. For a seasoned issuer coming to market, its securities trade with the benefit of full disclosure of material facts as at the date of the issuer's last annual information form and with the benefit of full disclosure of material changes up to the date in question. When the issuer comes to market the disclosure record will be augmented by a short form prospectus which will contain details of the offering, any consequent disclosure, such as use of proceeds (as expansive or cursory as may be appropriate), together with such additional information as the issuer and the underwriters believe is required to be disclosed. This offering document would not be subject to regulatory review in advance. The scrutiny of such an issuer by other market intermediaries would be regarded as sufficient. On an *ex post* basis, any issuer whose disclosure was inadequate could be denied C-WKSI status.

To ensure that speed be generated for the C-WKSI approach it is necessary to address the underwriter's requirement of due diligence, which is usually a time-consuming exercise, with the issuer's desire to access to the capital markets as quickly as possible—a difficulty that is common even under the POP system. To address the impediment to quick access, the Task Force concluded that the underwriter's certificate for C-WKSI offerings should reflect commercial reality—achieving speed to market sometimes means that something less than full-blown due diligence—and this fact should be acceptable to the regulatory system. The result is an underwriter certificate that talks about 'a review that is reasonable under the circumstances'. Note that this approach shifts a portion of the gatekeeping function played by the underwriter in its pre-offering due diligence review to the research analysts, media and institutional investors following the disclosures of a C-WKSI on a daily basis.

## **Private placements**

### *Broadening the 'accredited investor' category*

Another method issuers can use to access the capital markets is to 'privately place' securities using a prospectus exemption. For individuals, the most commonly used private placement exemption is the 'accredited investor' exemption. By measure of wealth, an accredited investor is regarded as being sufficiently financially sophisticated (or to be able to afford sophisticated advice) to purchase securities without a prospectus.<sup>14</sup>

The Task Force was concerned that a large number of investors are shut out of the



private placement market because of the size of their personal fortunes and recommended that the category of individual regarded as an accredited investor be broadened to include not only those who are wealthy, but also those who rely on a registered adviser in making their decision to invest in the private placement. The financial sophistication of the registered adviser, which comes from professional training and accreditation, would be transposed onto his client.<sup>15</sup> This recommendation would increase the investor base.

Broadening the class of eligible investors as recommended could increase the risk of unduly eroding the entire prospectus model. For this reason the Task Force recommended that, at the outset, this exemption be limited to 50 investors for any one private placement. Over time, consideration should be given to increasing the number of permitted investors who qualify under this exemption.

Other limits to the recommendation are as follows:

- The issuer must be a 'reporting issuer' (or the equivalent) under securities laws.
- The registered adviser would be prohibited from advertising to encourage investors to rely on this exemption and sales under this exemption would only be permitted to clients with whom the registered adviser had a pre-existing relationship.

## **Electronic Disclosure and Financial Literacy (Chapter 4)**

The Task Force focused on numerous questions related to investor decision making such as:

- How do investors make investment decisions?
- Is the form of presentation of public company disclosure adequate for investors' needs, to enable sound investment decisions to be made?

- What opportunity does an investor have to take reasonable steps to be informed prior to investing?

How do investors make investment decisions? First, the Task Force recognized that, while theoretical models assume that an investor is a person with unlimited ability to consider and access relevant information, filter out unwanted information and measure motives of all parties, in reality the typical retail investor falls far short of this ideal. Second, the Task Force appreciated that much of what is required to be disclosed under securities laws is difficult to digest. Although a high percentage of investors will consult an issuer's prospectus,<sup>16</sup> the dense technical language, sheer length of the document, jargon and volume of information easily results in information overload.<sup>17</sup> Keeping these points in mind, the Task Force focused on recommendations that increase the effectiveness of disclosure (as opposed to simply concentrating on volumes of information).

In attempting to increase the effectiveness of disclosure, the Task Force focused on the method by which information is communicated. There has been a movement to mandate the use of 'plain language' in disclosure documents (more so in other jurisdictions<sup>18</sup> than in Canada<sup>19</sup>). However, the challenge is ensuring that 'plain' disclosure is also 'full disclosure'. The tendency has been to err on the side of full disclosure and this pragmatic choice is based on the fact that many investors have the assistance of an expert to clarify complex disclosure. The Task Force recognized the danger of putting too much emphasis on plain disclosure and would prefer to direct regulatory focus on presenting information more effectively.

The current regulatory regime requires that a document be (i) made available for

public review and posted on the internet accessible System for Electronic Document Analysis and Retrieval ( 'SEDAR' ) (such a process being known as 'filing' ) and (ii) physically delivered by a reporting issuer to security holders or prospective investors (such a process being known as 'delivery' ). While National Policy 11-201—Delivery of Documents by Electronic Means provides guidance on electronic delivery of certain disclosure documents, the Task Force' s view was that the policy' s potential to reduce the burden of paper delivery was muted because of the requirement that paper delivery be reverted to in many instances.

SEDAR was created by the Canadian Securities Administrators (CSA). Filings with SEDAR started on 1 January 1997, and are now mandatory for most reporting issuers in Canada. SEDAR was a significant step in streamlining the filing of disclosure documents in that it has saved time and created a free and publicly accessible record of all disclosure documents. However, the Task Force has recommended some improvements to SEDAR including expanding its search capabilities and refining the category of document classification rather than relying on a catch-all category of 'Other Documents' .

Although there are some guidelines regarding the electronic delivery of documents (as opposed to filings under SEDAR), the potential of realizing electronic efficiency has been muted by the requirement that paper delivery be reverted to in many instances.<sup>20</sup> Keeping in mind the strengths of SEDAR, as a free, publicly accessible full record of disclosure documents, the Task Force focused on determining the most effective method of delivery. The Task Force cited statistics indicating that e-literacy is prevalent among most investors and that the number of investors who are not e-literate would not be

significant in number.<sup>21</sup>

With this in mind, the Task Force recommended that Canada should make the leap to ‘access equals delivery’ . ‘Access equals delivery’ means, quite simply, that the regulatory requirement to deliver a disclosure document to an investor will be satisfied by the investor being able to access that document using the internet. For example, under an ‘access equals delivery’ model, the posting of a disclosure document on SEDAR would satisfy both the filing and delivery requirements imposed by securities laws. There would be no requirement for paper delivery of disclosure documents to investors. The Task Force noted that paper production is extremely expensive and that to permit a few investors to demand paper disclosure, and thereby impose a cost on all shareholders of the issuer would largely thwart the cost savings of shifting to an ‘access equals delivery’ model. Investors would be able to print hard copies of documents on their own. Those investors that are e-illiterate could seek the assistance of their registered representative to obtain hard copies of the documents.

With respect to implementing ‘access equals delivery’ , the Task Force addressed the potential hurdle of obtaining consent of investors to have electronic delivery. Its position was that this hurdle should be removed not jumped. Consent should be implied in the decision to invest in a system where ‘access equals delivery’ is the accepted medium of information dissemination. Accordingly, the Task Force recommended that all delivery requirements be abolished and that all disclosure documents be required to be filed on SEDAR. The elimination of ‘delivery’ would render investor consent to ‘access equals delivery’ unnecessary.

In looking towards the future, the Task Force considered the possible use of new technology. One idea that has met with a great deal of enthusiasm has been the US Securities Exchange Commission's voluntary programme for reporting financial information using Extensible Business Reporting Language ( 'XBRL' ). XBRL allows for the 'tagging' of data items in a disclosure document, ie information is embedded in the text of a document which allows it to be identified by the computer—for example, the general and administrative expense line in a balance sheet would have its own unique tag. This allows the data to become 'alive' for the user. In January 2007, Canadian Securities Administrators (CSA) announced the establishment of a programme that would allow issuers to voluntarily file financial statements in XBRL format.<sup>22</sup> The purpose of the programme is to assist Canadian capital markets participants to gain practical knowledge and experience in preparing, filing and using XBRL information. The voluntary programme will also help the CSA assess the usefulness of XBRL as it considers whether to make filing in this format a requirement.

Another important point would be the move towards 'layered disclosure' . 'Layered' electronic disclosure would, in layer one, present a basic summary of the information to be communicated to the investor. The reader would then have the option to 'click' on a piece of information that is of particular interest and enter additional 'layers' , each with an increased level of detail. An additional advantage of electronic 'layering' will be the ability to 'pull' information from existing data sources. Computer and internet experts consulted by the Task Force have indicated that the technology necessary to implement the Task Force's recommendation is readily available and the Task Force named its design

'MERIT' —Model for Effective Regulatory Information Transfer.<sup>23</sup> The Task Force has recommended that serious consideration be given to the implementation of MERIT and XBRL technology. Until such time that MERIT has been adopted, it was recommended that paper-based disclosure be presented in layered format with each layer being of increasing depth and complexity, thereby allowing investors to determine the depth of disclosure which is informative for them.

Finally, given that an increasing number of Canadians are now responsible for managing their own retirement accounts, there is a renewed importance to investor education in addition to disclosure. It has also been noted that increasing levels of financial literacy also function to enhance the competitiveness of Canada's capital markets by increasing liquidity. However, there are indicators that a staggering two-thirds of Canadians are functionally illiterate when it comes to investment knowledge.<sup>24</sup> Although there have been investor education initiatives undertaken by members of the CSA, the Task Force noted that a national mandate would be required to sustain an education programme would be effective on a broad level. Accordingly, the Task Force recommended financial literacy be treated as a matter of national priority and that a national coordinator of public and private sector education initiatives be created.

## **Hedge Funds (Chapter 6)**

Hedge funds have demonstrated both large growth and significant controversy around the globe. Overall the Canadian hedge fund industry is estimated to include about \$26.6 billion in assets under management with approximately \$10 billion invested by Canadian pension funds, \$14.1 billion by Canadian individuals (\$6.4 billion in stand-

alone hedge funds and funds of hedge funds and \$7.7 billion in ‘principal protected notes’ ) and \$1.6 billion by foreign clients of Canadian hedge fund managers. While there has been growth in Canadian hedge funds they are smaller than hedge funds in the rest of the world. For example, nearly 30 percent of the hedge funds in Canada have assets under management in the range of \$10 – \$49 billion, whereas only 10 percent of global hedge funds have assets in this range. Further, only 4 percent of the Canadian hedge funds have assets in excess of \$5 billion whereas global hedge funds have 21 percent reporting assets larger than \$5 billion.<sup>25</sup>

However, fewer assets do not translate into a lack of concerns; there have been a number of hedge fund problems. Two of the more recent hedge fund blow-ups in Canada were reviewed for the task force.<sup>26</sup> The researcher concluded that their failure was not a problem of inadequate regulation. The investment strategies were complicated and monies were not invested as indicated in the offering documents but used to pay operating expenses, including performance fees. The author also concludes that ‘enhanced regulatory oversight through a timely investigation or examination into the business and affairs of these companies would likely have revealed a handful of significant issues in the operations of these companies that could have led to an earlier discovery of what actually was going on...’<sup>27</sup> The problems associated with hedge funds have resulted in increased attention by regulators across the world.

There are many benefits that accrue to investors and the economy from a vibrant hedge fund industry. These include better liquidity in capital markets; expanded choices for investors to construct more effective portfolios; and improved market efficiency.

These factors improve the competitiveness of capital markets. Part of the improvement is an increased ease of investors, both retail and institutional, to access these funds. In addition, hedge funds represent a valuable pool of capital market talent which should be fostered and not discouraged from conducting legitimate operations in Canada.

However, concerns continue to exist regarding hedge funds and not just in the case of the extreme event of bankruptcy. These concerns are related to the structure of the hedge funds and include the following: valuation of hedge fund assets in strategies where underlying assets do not have liquid markets; effectiveness of internal control systems; lack of understanding of investment strategies by investors; incentives for fraud; and inadequate disclosure of fees, expenses and potential for conflicts of interest. Increasing competitiveness requires that investors be comfortable with investing in the securities and that hedge fund issuers/managers have the ability to generate products.

Hedge funds in Canada are generally organized in one of the three commercial structures: (i) stand-alone hedge funds, (ii) funds of hedge funds and (iii) principal protected notes. A principal protected note is a form of 'structured' investment product which derives its value based on the movement of an underlying investment, such as, but not exclusively, a hedge fund. 'Principal protected notes' guarantee that at maturity the principal amount of the investors' investment will be returned.

The major banks were the first to issue structured products in Canada. In 2002, independent (ie non-bank) managers began to structure and distribute principal protected notes, using hedge funds (usually funds of hedge funds) as the underlying investment. Independent managers of principal protected notes work in partnership with



banks (or Crown Corporation) to structure these financial instruments. The notes are sponsored and distributed by the manager but issued by the bank (or Crown Corporation). As of March 2005, it is estimated that 24 percent of the principal protected note market was structured with a hedge fund as the underlying investment.

### **Current regulatory regime**

#### *Exempt trades*

The distribution of securities in hedge funds, like the distribution of other securities in Canada, must be completed using a prospectus or in reliance on a prospectus exemption. There have been few (if any) hedge fund offerings by way of prospectus in Canada—few hedge fund managers are inclined to voluntarily make the detailed disclosure required in a prospectus and the subsequent continuous disclosure rules upon the hedge fund becoming a reporting issuer. Thus, investors in hedge funds are limited to those who meet the definition of ‘accredited investor’ under NI 45-106 or who have the means to invest more than \$150,000—ie wealthy Canadians.

#### *Exempt securities*

The distribution of all principal protected notes is an important exemption to the earlier noted process. These products are typically structured as an ‘evidence of deposit’ such that they fall outside of the legislative framework that applies to publicly traded securities and mutual funds. The returns on such notes are sometimes linked to the performance of hedge funds or funds of funds that themselves are not reporting issuers offering securities by prospectus. Thus, retail investors can buy a hedge fund which is sold both without a prospectus and to investors who are not deemed wealthy or sophisticated by securities

legislation.

Current regulation generates an ill-advised and contradictory result. On one hand, direct investments in hedge funds are generally limited to those investors qualifying to purchase an exempt security, ie the wealthy. At the same time, however, any investor (regardless of wealth) is permitted to purchase principal protected notes with an underlying hedge fund, via the 'backdoor' without the full protections afforded by securities laws because principal protected notes are regarded not as securities or as exempt securities.

### **Regulatory recommendations**

Regulating hedge funds may actually increase market participation. The Task Force recommendations started from the premises that hedge fund investing represents a viable and attractive alternative investment strategy and that innovation should not be stifled. This trade-off needs to be examined carefully and the Task Force strongly recommended that any changes be subject to a CBA.

The Task Force's recommendations pertaining to hedge funds were designed to establish a regulatory framework that would permit hedge funds to be widely sold to the public. To this end, retail investors need to be able to access all of the information necessary to make informed investment decisions regarding hedge funds and principal protected notes linked to hedge funds. The regulatory recommendations were in the areas of disclosure, principal protected notes and regulation of managers.

### ***Disclosure***

The features of the disclosure regime are as follows:

- Full disclosure of all performance, management, administrative, referral and other fees (including the compensation of the investment adviser and manager).
- A description of the relationship between the hedge fund manager, adviser, administrator and prime broker, and appropriate cautionary language regarding any conflicts of interest between them.
- Mandatory disclosure of any ‘side letter’ and other collateral agreements between the hedge fund and investors who receive special fee or liquidity arrangements.
- An independent process or mechanism to value the assets of the hedge fund.
- A description of the hedge fund structure and its investment strategies.
- In the case of principal protected note products linked to hedge funds, a full description of the underlying hedge fund or fund of a hedge fund incorporating all of the features listed earlier.
- A custodian or custodian-like capability be required at each hedge fund.

#### *Principal protected notes linked to hedge funds*

Two recommendations were made to try to ensure that retail investors purchasing principal protected notes linked to hedge funds are afforded some protection.

First the distribution of principal protected notes where the economic value is based upon an underlying hedge fund should be regulated according to the nature of the underlying investment rather than the exemption accorded to the principal protected note with which the underlying investment is ‘wrapped’ .

Second, all financial intermediaries selling hedge fund products and other structured products linked to an underlying hedge fund should be required to meet certain proficiency requirements to ensure that they properly understand the products they are selling.

#### *Manager registration*

Hedge funds are particularly vulnerable to operational risks associated with poor

management. Despite this, many hedge fund managers (unlike advisers, in Canada) are not registrants under securities legislation, and therefore escape regulatory oversight. Accordingly, there is no safeguard in place to ensure that a hedge fund manager has adequate capitalization, appropriate internal controls or, at the most basic level, whether the manager's principals are fit to manage investors' money.

Accordingly, the Task Force recommended that consideration be given to the registration of hedge fund managers in order to ensure that there is an appropriate level of regulatory oversight of the activities of the manager as well as its capitalization and governance procedures. While recognizing that a similar proposal requiring hedge fund managers to register as advisers in the US was met with resistance and, ultimately, judicial intervention, the Task Force did not believe that these events should forestall consideration of its recommendation.

Subsequent to the release of the Task Force report, the Canadian Securities Administrators, a council of provincial and territorial securities regulators that coordinates and harmonizes regulation for the Canadian capital markets released the results of its review of hedge funds in Canada. Many of the same topics were identified, including the registration of fund managers.

## **Enforcement (Chapter 7)**

For many investors, a key question is the extent to which existing Canadian securities laws are enforced. Enforcement was relevant to the Task Force because it relates to the enhancement of the competitiveness of Canadian capital markets. 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 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.<sup>28</sup>

Although it is clear that improvement to enforcement of Canadian securities laws is required, the Task Force was also appreciative of the unique attributes of Canadian capital markets and that, correspondingly, enforcement policy should also be guided by such unique attributes as well as Canada's legal traditions. Enforcement successes in the US should not prompt us to transplant US enforcement practices without regard to Canadian circumstances. Thus, the Task Force commissioned research from The Honourable Peter Cory and Prof. Marilyn Pilkington<sup>29</sup> (the 'Cory and Pilkington Report' 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 enforcement and the balance between regulatory and criminal enforcement.<sup>30</sup>

There was concern that the 'contrary to the public interest' provision in securities legislation may be abused as a 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 Task Force suggested that if an offensive pattern of

behaviour is identified, it should be addressed clearly in a regulatory notice; this notice would advise market participants that such conduct, if continued, would be considered contrary to the public interest and sanctioned appropriately.

Due to the geographical proximity of the US, Canadian enforcement is invariably compared to that of the US. The high visibility of securities law enforcement action in the US has led many Canadian investors (justifiably or not) to conclude that Canadian regulators are failing in this area. However, it is important to understand the difficulties in trying to make a useful comparison between the enforcement activities in the two countries. This is not to say that such a comparison has no utility. Rather, the issues central to such a comparison must be understood.

Thus, the Task Force commissioned research to draw comparisons between Canadian and US enforcement systems.<sup>31</sup> Professor Howell Jackson compared the budgets and staffing levels for securities regulators in the US and Canada, collected data on enforcement activity in Canada and followed that with a comparison of enforcement activity between US 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 US.
- However, Canadian regulatory budgets per staff member are lower than their counterparts in the US, with the US budgets per staff member being about 60 percent higher. He does not believe that there is evidence that more Canadian personnel are 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 US even when one performed scaling adjustments. However, more recent data indicates that, given plausible scaling factors, Canadian public enforcement is roughly comparable to the US (though private enforcement is still much lower). Nevertheless, Prof. Jackson cautions that drawing comparisons is difficult since one could

compare based on many different factors such as 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 Prof. Jackson cautions against moving towards a US system of class actions as there are many reasons to believe that this form of the US litigation system is inefficient and inequitable.

The Task Force was greatly assisted by the Cory and Pilkington Report and, for the most part, found itself in agreement with the recommendations contained therein. A summary of the recommendations is as follows:<sup>32</sup>

- *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. Integrated Market Enforcement Teams ( ‘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 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.<sup>33</sup>
- *Penalties and orders*: Legislatures should consider enacting laws similar to section 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 legislations) to order compensation or restitution under a fair set of rules.
- *Self-regulatory organizations (SROs)*: The roles and jurisdiction of SROs should be reviewed. Such a review would consider, with respect to SROs, the applicability of the 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 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.

### 3. Areas for future consideration



## The Role of Gatekeepers (Chapter 8)

Capital markets rely on gatekeepers. Gatekeepers such as auditors, securities analysts, credit rating agencies, lawyers and investment banking firms all play a significant gatekeeping role in assisting issuers in raising funds and/or maintaining a market.

Securities analysts have recently been the focus of criticism, particularly because of their significant ratio of buy to sell recommendations (sometimes computed in the US at levels as high as 100 – 1), their perceived bias towards optimism, and their willingness, in some instances, to endorse the stocks of underwriting clients even when they had personal misgivings. Although there has been significant US and Canadian reform, recent research suggests that such reform may not have been that effective given the persistence of high ratios of buy- to- sell recommendations. Even worse, recent reforms have been costly and have led to a drastic reduction in the employment of securities analysts.<sup>34</sup>

Securities analysts are currently caught in many conflicts. The analyst presumably knows that his or her utility to their firm comes from the revenues that the analyst indirectly generates for the firm; thus, the firm's clients cannot safely be offended. Conflicts include personal conflicts (eg analyst owning the stock that is being analysed), brokerage commission conflicts (buy recommendations tend to generate more commissions for the analyst's employer), investment banking conflicts (there is a tendency to inflate the ratings of a firm's clients), issuer access conflicts (even if the issuer is not a client, issuers tend to release information only to 'friendly analysts' ) as well as buy side conflicts. Some studies also suggest that analysts tend to 'herd' such that most analysts refrain from straying far from a consensus prediction of other analysts.

Despite the problems with analyst research it is unsatisfactory to accept that the choice is between conflicted research and no research. Past attempts to diminish investment banking personnel from influencing analyst compensation as well as attempts to shield analysts from pressure and retaliation do not seem to have succeeded in addressing the problem. A possible escape from this trade-off between adequate coverage and meaningful independence is to create a subsidy for research that insulates the analyst from the control of conflicted persons. Justifications for this include (i) securities research is a 'public good', the private market cannot supply it adequately; (ii) broker-dealers today have less freedom to control securities research, they cannot earn the same profits from it as in the past and so have reduced their funding for securities research within their firm and (iii) securities research has long focused on those stocks that trade the most heavily, but the Canadian market is characterized by a preponderance of small capitalization stocks. Furthermore, it has been suggested that Canadian exchanges could require that no company can trade without at least one analyst. The exchanges could hire analysts for 'uncovered' companies (passing on the costs to its members and listed companies). Such an approach could be more objective and neutral since it would be the exchange appointing the analyst as well as more efficient since the exchange may be able to take advantage of economies of scale in hiring analysts. The Task Force did not go so far as to list subsidized research analysis as one of its 65 recommendations, but thought it was a fruitful proposal for reflection and consideration by capital markets stakeholders.

## **Insurance Against Misinformation (Chapter 9)**

As in any economic endeavour, innovation is a key driver of success. In the capital market context, success is measured in terms of liquidity and capital using the markets. This success requires institutions and regulation that encourage innovation while protecting investors. Examples of these innovations include the creation of the Alternative Investment Market and the Nominated Adviser (NOMAD)<sup>35</sup> concept in the UK and the introduction of the ‘well-known seasoned issuer’ concept in the US. The Task Force was of the opinion that Canada needs to embrace innovation not for its own sake but to encourage competition.

The Task Force was cognizant that its recommendations to modernize Canadian capital markets are by and large evolutionary, a process that entails building on what is already in place and attempting to make it better. The Task Force had no qualms in pointing this out.

Nonetheless, the Task Force wondered whether it was time for the introduction of a bold, innovative step as a means of distinguishing Canada’s capital markets. The innovation is the introduction of insurance against misinformation loss in the capital markets. To this end the Task Force commissioned two research papers. The first paper was conceptual and looked at the cost and benefits of potential insurance designs.<sup>36</sup> The second paper addressed the question of whether such insurance could be priced and hence offered using an actuarial perspective.<sup>37</sup> This paper took an actuarial perspective. Risk in capital markets is pervasive and ranges from market risk and firm-specific risk related to the specific operations of the firm. However, there is another source of risk that investors face—misinformation risk, referred to in the report as ‘behavioural risk’. This

risk is the result of the behaviour of management and is manifest in events in which there is inadequate, inaccurate and untimely disclosure of information to the market. While insurance schemes currently exist in capital markets (eg bank deposit insurance, investor protection funds), the insurance scheme against misinformation is unique. Its purpose is to tell investors that subject to the dollar limits of the programme, if you choose to participate in the Canadian equity markets, there will not be a loss of funds due to misinformation events. This approach is in contrast to the current protection investors have through the impact on behavioural risk by securities law and enforcement and the possible recovery after protracted proceedings in the event of a misinformation event.

A second, market-related solution to the problem is an indirect one and arises through the construction of well-diversified portfolios. While there is some question of the diversifiability of this type of event it is clear from the research undertaken by the Task Force that retail investors do not hold diversified portfolios, and hence are subject to the impact of this risk.

In thinking about the insurance programme, the Task Force posed two fundamental questions: (i) would such a programme be a net benefit to investors? and (ii) could such a programme be beneficial in enhancing the competitiveness of Canada's capital markets? Both of the research reports addressed these questions. Professor Baker, after expressing some concern over the need for a new insurance programme for misinformation events, argued that a securities misinformation programme had the potential to provide systemic benefits to the Canadian capital market for two reasons. First, the programme would improve compliance with securities laws resulting from cost internalization by issuers and governance efforts by the securities misinformation insurance programme; second, there

would be enhanced investor confidence in the Canadian capital market from the signalling effect of what amounts to a warranty of compliance with the disclosure requirements. Professor Panjer states that the idea of an investor protection programme is to protect investors in order to develop greater confidence in the securities market. The greater confidence in an insured market enhances its competitiveness by differentiating Canadian markets from uninsured markets.

We have chosen not to present the specifics of the alternative insurance programme design schemes along with the associated issues of funding and costs (eg Who can make a claim? Against whom can a claim be made and for what damage? How would the program be funded?). While interesting, these discussions can be accessed by the interested reader. Our purpose is to identify the major reasons for the program and how it could achieve its policy purpose of distinguishing Canadian capital markets from others, thereby improving Canadian capital market competitiveness.

#### **4. Conclusions**

The idea that capital markets are crucial to an economy's functioning is uncontested. Regulators around the world are considering how their capital markets can maintain or improve their functioning in a world in which there is increased competition for capital. Recently the SEC proposed rule changes to increase the attractiveness and competitiveness of the US capital markets following on the increased costs of complying with section 404 and the Sarbanes – Oxley Act of 2002. In addition, the Committee on Capital Markets Regulation, an independent group of stakeholders in the US capital markets, was formed

in September 2006. Its mandate was to conduct a major study of how to improve the competitiveness of the US public capital markets. It released its first report in November 2006.<sup>38</sup>

The Task Force considered what Canada's capital markets, and their regulation, would look like if its recommendations were adopted. The picture relating to the recommendations we considered in this article could look like this:

- The alternatives for investment diversification, or concentration, would be thoroughly explained to investors by qualified investment advisers who would disclose the comparative costs of available options. Investment advisers recommending specialized investment products would be qualified to give that advice by virtue of product-specific education.
- Investors wishing to be informed prior to an investment decision would be attracted to disclosure presented in a user-friendly manner, readily able to be penetrated and absorbed at varying levels of complexity, to suit their needs and abilities.
- Senior issuers would have immediate access to the market to raise capital without the delay of regulatory oversight of their offering document.
- Regulators, consequentially, would be able to focus their attention in areas where external gatekeepers are less common and less central to the regulatory system.
- Issuers would benefit from the savings which would result from the end of the 'paper world', accepting the reality of the 'e-world' being today's disclosure medium for virtually all investment products.
- It would be commonly regarded as a serious mistake in judgment to contravene Canada's securities laws, due to a focused and effective enforcement system—particularly due to the recommendations to invigorate the investigative, prosecutorial and adjudicative functions in the securities law enforcement system.
- Lastly, as a result of the foregoing, the 'made in Canada' discount might become a 'made in Canada' premium and the competitiveness of Canada's markets would be markedly enhanced.

Having met its mandate and goal, the Task Force concluded that it is now up to the regulators, legislators and others to determine to what extent this vision is achieved.

## Appendix

### Summary of Task Force recommendations

#### Recommendations regarding approaches to securities regulation and general principles

1. The Task Force recommends that Canadian securities legislation include as one of its purposes the enhancement of the competitiveness of Canada's capital markets.
2. The Task Force recommends that rules that are enacted in anticipation of a market failure be revisited on a regular basis to determine whether market forces are able to address the issue in the absence of regulatory intervention.
3. The Task Force recommends that prior to enacting new rules to address a market failure, a thorough and systematic review of existing rules should be undertaken to determine whether, if enforced, existing rules are adequate. This requires that the regulator clearly define the failure that is to be addressed and the outcome which the rule is intended to produce, including identifying measurements to be used to determine whether the failure has been addressed adequately.
4. The Task Force recommends that all securities regulators in Canada undertake empirical cost – benefit analyses prior to the introduction of a significant new rule.
5. The Task Force recommends that a uniform set of published guidelines be established outlining the methodology to be used in cost – benefit analyses.

6. The Task Force recommends that each cost – benefit analysis include a clear description of the uncertainties (ie the predictions, assumptions, forecasts, etc. that have been applied) that are associated with the analysis.
7. The Task Force recommends that third-parties affected by a proposed rule be encouraged to undertake their own cost – benefit analysis for consideration by securities regulators.
8. The Task Force recommends that where regulations are adopted despite evidence that their expected benefits are less than the expected costs, securities regulators be required to explain why they have adopted the rule. Moreover, there should be a mandatory re-evaluation of such rules after a set period of time to ensure that the objectives of the rule are still being met.
9. The Task Force recommends that an independent body, staffed by capital markets experts from all stakeholder groups, be established for the specific purpose of conducting, at defined intervals, a systematic cost – benefit analysis of every significant regulatory intervention into capital market activity.
10. The Task Force recommends that Canadian securities regulation be based on clearly enunciated regulatory principles which do not need a detailed set of interventionist rules for sound implementation.
11. The Task Force recommends that regulation be scaled according to the size of an issuer' s market capitalization and other issuer-specific considerations in order to ensure that regulation is appropriate.



## Recommendations regarding understanding how investors make investment decisions and better meeting the needs of investors

12. 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.
13. The Task Force recommends that:
  - the search features of SEDAR be expanded to allow for more detailed searches of disclosure documents, and
  - the taxonomy for disclosure documents filed on SEDAR be further refined to reduce the dependence on the use of ‘catch-all’ categories.
14. The Task Force recommends the adoption of a full ‘access equals delivery’ system. Specifically, we recommend:
  - 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
  - that the elimination of any requirement to ‘deliver’ a document would render investor consent to ‘access equals delivery’ unnecessary.
15. The Task Force recommends that MERIT (Model for Effective Regulatory Information Transfer) be thoroughly considered and that securities regulators encourage and facilitate the use of XBRL, information layering and interactivity within electronic disclosure documents, all as detailed in the technical White Paper included at Schedule 4-A.
16. The Task Force recommends that, until MERIT and the use of XBRL can be

implemented, paper-based disclosure be presented in layered format with each layer being of increasing depth and complexity, thereby allowing investors to determine the depth of disclosure which is informative for them.

17. The Task Force recommends that financial literacy be treated as a matter of national priority.
18. The Task Force recommends the creation of a national coordinator of public and private sector investor education initiatives.
19. The Task Force recommends that further study be undertaken by capital markets stakeholders to design programmes that ensure that the objective of financial literacy as a national priority is achieved.
20. The Task Force recommends that insiders of an issuer be obliged to give at least two business days advance notice of their intention to sell some or all of their securities in the issuer.

### **Recommendations regarding accessing the Canadian capital markets**

21. The Task Force recommends that a Canadian version of the ‘well-known seasoned issuer’ concept be introduced in Canada to allow eligible issuers the ability to access the capital markets with increased speed.
22. The Task Force recommends that Canadian well-known seasoned issuer (C-WKSI) status be granted to those issuers meeting the qualification criteria for the POP system and with market capitalizations of \$350 million and over.
23. The Task Force recommends that C-WKSIs be permitted to come to market in a

follow-on offering with an offering document (that would not be subject to regulatory review) which contains only the details of the offering, the use of proceeds and related disclosure which would be tantamount to a material change statement.

24. The Task Force recommends that the certificate of a C-WKSI using a C-WKSI offering document speak only to material facts as at the date of the C-WKSI's last annual information form and material changes since that date, specifically saying:

'The foregoing, together with the documents incorporated by reference herein, constitutes full, true and plain disclosure of all material facts as at [the date of the last filed Annual Information Form] and of all material changes in the business and affairs of [issuer] since that date.'

25. The Task Force recommends the underwriter's certificate for offerings by C-WKSIs take into account the restricted time that underwriters will have to complete a full-blown due diligence review of the issuer, specifically saying: 'To the best of our knowledge, information and belief, based on a review reasonable under the circumstances, the prospectus constitutes full, true and plain disclosure of all material facts as at [the date of the last filed Annual Information Form] and of all material changes in the business and affairs of [issuer] since that date.' We would expect that securities regulators would provide guidance as to how the standard of reasonable review could be achieved.

26. The Task Force recommends broadening the category of individual regarded as an accredited investor under the private placement exemptions to include not only those who are wealthy, but also those who rely on a registered adviser. The limits on

this exemption would be: (i) sales (utilizing the exemption) limited to no more than 50 investors for any one private placement, (ii) the issuer must be a 'reporting issuer', and (iii) a registered adviser would be prohibited from advertising to encourage investors to rely on this exemption and sales under this exemption would only be permitted to clients with whom the registered adviser had a pre-existing relationship.

27. The Task Force recommends that hold periods for privately placed securities of reporting issuers be eliminated.

### **Recommendations regarding the regulation of hedge funds**

28. The Task Force recommends that a regulatory framework be established for the public offering of hedge funds just as a regulatory framework was established for the public offering of mutual funds and that while the framework will incorporate full regulation some of the features will be as follows:

- full disclosure of all performance, management, administrative, referral and other fees (including the compensation of the investment adviser and manager),
- a description of the relationship between the hedge fund manager, adviser, administrator and prime broker and appropriate cautionary language regarding any conflicts of interest between them,
- mandatory disclosure of any 'side letter' and other collateral agreements between the hedge fund and investors who receive special fee or liquidity arrangements,
- a description of the mechanism or process by which the assets of the hedge fund are valued,
- a description of the hedge fund structure and its investment strategies and
- in the case of principal protected note products linked to hedge funds, a full description of the

underlying hedge fund or fund of hedge funds incorporating all of the features listed above.

29. The Task Force recommends that the distribution of principal protected notes where the economic value is based upon an underlying hedge fund be regulated according to the nature of the underlying investment rather than according to the exempt character of the related principal protected note with which the underlying investment is 'wrapped' .
30. The Task Force recommends that all financial intermediaries selling hedge fund products and other structured products, such as principal protected notes linked to an underlying hedge fund, be required to meet certain proficiency requirements to ensure that they properly understand the products they are selling.
31. The Task Force recommends that consideration be given to the registration of hedge fund managers in order to ensure that there is an appropriate level of regulatory oversight of the activities of the manager as well as its capitalization and governance procedures.

### **Recommendations regarding the enforcement of securities laws**

32. The Task Force recommends that a co-operative national programme be established and funded by securities regulators, self-regulatory organizations (SROs) and law enforcement agencies: (i) to establish priorities for enforcement, (ii) to develop reporting systems that would provide a basis for assessing the effectiveness of enforcement processes in achieving their objectives, (iii) to identify and collect any additional relevant data, and (iv) to report the data and their qualitative analysis of

it to an independent research body which will evaluate and issue public reports on the effectiveness of enforcement processes.

33. The Task Force recommends that a study be undertaken to assess the needs for police services in the investigation of capital market crime in various jurisdictions, and to inquire into the appropriate contributions that should be made by municipal, provincial and federal police services.
34. The Task Force recommends that a study be undertaken to assess the needs for investigative services by securities regulatory authorities in various jurisdictions, and the capacity to provide those services effectively.
35. The Task Force recommends that if the Integrated Market Enforcement Teams (IMETs) established by the Royal Canadian Mounted Police are to succeed, there must be a renewed and continuing commitment to developing and retaining the expertise required to lead and conduct complex investigations of capital markets offences by:
  - identifying and reviewing the competencies that are required,
  - recruiting officers and other staff with specialized backgrounds,
  - providing professional development and mentoring programmes,
  - establishing and complying with policies that restrict secondments of these officers to other duties, and
  - establishing and complying with promotion policies that enable investigators to establish long-term careers in the investigation of capital market crimes.
36. The Task Force recommends that either the capacity of IMETs should be expanded to conduct all the necessary criminal investigations relating to capital markets, or the

capacity of other police agencies should be enhanced in order to address the kinds of cases that IMETs is not authorized or able to undertake.

37. The Task Force recommends that the role of IMETs in each locale should be defined in accordance with the investigation needs in that locale, without diluting the overall mandate and accountability of IMETs.
38. The Task Force recommends that to make the best use of limited investigative resources within each jurisdiction, it will be necessary to establish processes for consultation, co-operation and co-ordination among all levels of police forces and the enforcement staff of securities regulators.
39. The Task Force recommends that IMETs and other police forces recognize the prime responsibility of securities regulators to intervene early in a securities matter to preserve assets, protect investors, and, if possible, protect the long-term viability of the issuer. They should co-operate in obtaining and sharing evidence and information both to support that responsibility, and, as appropriate, to investigate suspected crimes with a view to prosecuting those responsible.
40. The Task Force recommends that consideration should be given to processes for focusing and expediting investigation, and ensuring quality control and the exercise of good judgment. What is needed, in each IMET locale and each securities regulator, is an experienced lawyer with the seniority, status and confidence to exercise independent and sound judgment, a record of skills in supervision and management, and expertise (or the ability to acquire it expeditiously) in the specialized field of capital markets regulation. The role of this individual, whom we

refer to as a ‘Senior Independent Review Officer’ , would be to provide focus, supervision and a locus of accountability for strategic decisions in an investigation. He or she should have status similar to that of a Securities Commissioner. 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.

41. The Task Force recommends that investigators have access to effective legal advice in the course of an investigation. However, it must be provided by individuals who will not be involved in the prosecution of the case.
42. The Task Force recommends that every effort be made to enable IMETs to complete current investigations expeditiously and in a focused manner.
43. The Task Force recommends that consideration be given to the accountability structure for IMETs, and the need to develop a national enforcement strategy that takes into account the strategic importance of investigation to the effectiveness of securities regulation in the provinces.
44. The Task Force recommends that in light of concerns expressed about constitutional hurdles to the sharing of information by regulatory investigators and police investigators, protocols be developed to guide those who must determine and substantiate the point at which a regulatory investigation crystallizes into an investigation for the purpose of criminal or quasi-criminal prosecution, and specifying the investigatory techniques that can be employed at various stages of



inspection and investigation.

45. The Task Force recommends that the securities regulator's Senior Independent Review Officer, recommended in recommendation 40, should also have independent authority to determine whether a matter should be sent forward for hearing by the securities tribunal.
46. The Task Force recommends that processes should be instituted for identifying priorities in the investigation and prosecution of regulatory matters, and ensuring that enforcement processes are being used effectively in addressing those priorities.
47. The Task Force recommends that the securities regulator's Senior Independent Review Officer, recommended in recommendation 40, should also have independent authority to determine whether a matter should be sent forward for prosecution as a provincial offence.
48. The Task Force recommends that where the Senior Independent Review Officer has authorized prosecution of a provincial offence, it may be appropriate to authorize counsel employed or retained by the securities regulator to prosecute it. The provincial prosecution service should provide guidelines to assist in ensuring that such counsel are thoroughly familiar with the principles that govern the role of a prosecutor.
49. The Task Force recommends that every effort be made to develop a nationally co-ordinated programme for the prosecution of capital markets cases, with a view to ensuring the development of a public prosecution service that has the experience, capability and commitment to meet the difficult challenge of prosecuting capital

market offences.

50. The Task Force recommends that the adjudicative functions of securities commissions be transferred to an independent tribunal or tribunals. Membership in the tribunal should be structured so as to ensure its expert knowledge of law, procedure and the operation of capital markets. Consideration should be given to the establishment of a national tribunal which could deploy hearing panels throughout the country as needed.
51. The Task Force recommends that the National Judicial Institute ( 'NJI' ) develop programmes to prepare judges to manage the adjudication of complex offences relating to capital markets and to understand the contexts in which they arise. The NJI should call upon the Canadian Securities Administrators, SROs and experienced counsel (for the prosecution and the defence) to participate in these programmes.
52. The Task Force recommends the establishment of a separate capital markets court to which jurisdiction, both provincial and federal, is ceded. Such a court would have jurisdiction with respect to all capital markets regulatory offences and could potentially be granted jurisdiction over civil liability cases arising from capital markets regulatory violations.
53. The Task Force recommends that legislatures consider enacting legislation similar to section 380.1 of the Criminal Code of Canada, to specify 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.
54. The Task Force recommends that, so far as possible, the penalties and orders

available for the enforcement of securities laws should be harmonized across the country yet applied with regional sensitivity.

55. The Task Force recommends that ministries and regulators review and harmonize provisions governing costs in securities matters, and consider adopting best practices of other jurisdictions, which should include:

- authorizing the regulator to order costs in favour of the respondent in appropriate circumstances;
- developing policies and guidelines regarding the circumstances in which costs may be ordered, the basis upon which costs will be calculated and the manner in which the respondent may test their calculation;
- providing for review of costs orders by a person or body independent of the regulator; and
- providing for the recovery of costs on usual principles, rather than requiring the payment of costs on the basis of full cost recovery to fund the investigation, prosecution and adjudication of securities matters.

56. The Task Force recommends that when regulators identify a course of conduct that breaks no specific provision of securities laws, but arguably contravenes a declared principle of the law and is considered to be contrary to the public interest, they notify the capital markets that the course of conduct is unacceptable and will, if repeated, attract prosecution.

57. The Task Force recommends that the ‘contrary to the public interest’ regulatory tool be used sparingly and only with the greatest care if the behaviour which is criticized has not been publicly identified in advance as unacceptable. Where the behaviour that is criticized has not been publicly identified, the contrary to the public interest provision should only be used if the conduct is egregious and a reasonable person in

the circumstances would view it to be contrary to the public interest. If the conduct is not egregious, the public should be duly warned before any enforcement action is taken. The risk that so-called ‘gotcha’ enforcement brings the entire securities enforcement apparatus into disrepute must not be overlooked.

58. The Task Force recommends that

- securities regulators consider utilizing their jurisdiction to apply to courts more frequently for restitution, compensation and/or damages on behalf of aggrieved persons,
- regulators and ministries should consider whether any further statutory provisions or regulations are required in order to provide the basis upon which these procedures may be invoked and
- regulators should develop practice guidelines to facilitate appropriate use of these procedures.

59. The Task Force recommends that consideration be given to authorizing securities tribunals to order compensation or restitution in appropriate circumstances.

60. The Task Force recommends that consideration be given to

- authorizing courts adjudicating capital markets offences under provincial or criminal legislation, and in appropriate circumstances, to make orders of restitution and compensation, and
- establishing rules to ensure the fairness of the process.

61. The Task Force recommends that securities regulators and Ministries monitor developments in class actions for failures of disclosure, with particular attention to concerns about the effective management of class actions.

62. The Task Force recommends that the appropriate roles and jurisdiction of SROs in the enforcement of standards within the securities industry and the assessment of penalties be reviewed. In particular, consideration should be given to

- whether SROs are exercising statutory powers of decision in their discipline jurisdiction and are

subject to the protections guaranteed by the *Charter of Rights and Freedoms*,

- in what circumstances and by what means SROs should be able to obtain production of documents from, and the attendance as witnesses of, former members and other third parties,
- the means, if any, by which the decisions of SROs should be enforceable against former members, and
- the circumstances and process by which an SRO could apply to a court for the appointment of a monitor.

63. The Task Force recommends the provision of immunity from civil liability for those acting in good faith on behalf of SROs.

64. The Task Force recommends that regulators consider the extent to which the new processes and requirements which have been established by SROs to provide arbitration and dispute resolution options to claimants should now be required, as a condition of recognition, for all SROs.

65. The Task Force recommends that regardless of 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.

## End Notes

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- 1 L. Hail and C. Leuz, *'International Differences in the Cost of Equity Capital: Do Legal Institutions and Securities Regulation Matter?'* J Acc Res. (2006) 485 – 531.
  - 2 M. King and D. Segal, *'Market Segmentation and Equity Valuation: Comparing Canada and the United States'*, Working Paper, University of Toronto, (July 2006).
  - 3 R. Morck and B Yeung, *'Some Obstacles to Good Corporate Governance and How to Overcome Them'*, vol 4 of the Report.
  - 4 C. Leuz and P. Wysocki, *'Capital Market Effects of Corporate Disclosures and Disclosure Legislation'*, vol 2 of the Report for a discussion of the literature in the context of disclosure.
  - 5 [www.tfmsl.ca](http://www.tfmsl.ca) for the Task Force and [www.ida.ca](http://www.ida.ca) for the IDA for the Capital Markets Institute.
  - 6 This section relies on the research paper by L. Schwartz *'Cost-Benefit Analysis of Canadian Securities Regulation'* at vol 4 in the Report.
  - 7 Interim Report Summary of the Committee on Capital Markets Regulation, *'The Committee's Key Recommendations-Reducing Regulation and Litigation While Enhancing the Rights of Shareholders.'* at 4.
  - 8 See Securities Offering Reform, Securities Act Release No. 33-8591 (19 July 2005) (adopting release) and Release No. 33-8501 (3 November 2004) (proposing release).
  - 9 The WKSI category covers companies that have filed periodic reports with the SEC for at least one year (and are current in those filings) and that (i) have outstanding a minimum US\$700 million in market value of equity held by non-affiliates, or (ii) have issued US\$1 billion in aggregate in non-convertible securities in the preceding three years. See United States Securities Act of 1933 Rule 405.
  - 10 A. Pritchard, *'Well-Known Seasoned Issuers in Canada,'* in vol 5 at 10.
  - 11 *Ibid.*, at 10.
  - 12 The SEC's second eligible category of WKSI—issuers selling more than US\$1 billion (approximately Can\$1.15 billion) in debt over the past three years—appears to be of limited importance in the Canadian context since only one issuer would have sold more than that amount of debt in public debt offerings between 2002 and 2004. Thus, equity market capitalization is the focus for the threshold analysis.
  - 13 *Ibid.*, at 16.
  - 14 The use of individual's wealth as a proxy for financial sophistication was questioned by some submissions. Larger financial wealth was more likely an indicator of a greater amount to lose.
  - 15 This recommendation is not without precedent. Examples found in US securities legislation are noted in the Report, cha 5, fn 21.
  - 16 R. Deaves, C. Dine & W. Horton, *'How are Investment Decisions Made?'* at 263 in vol 2 of the Report.
  - 17 D. Kingsford Smith, *'Importing the E-World into Canadian Securities Regulation'* in vol 5 of the Report at 304.
  - 18 See for example, (i) the European Union *Prospectus Directive; Commission Regulation (EC) No. 809/2004*; and, (ii) the United States Securities and Exchange Commission, *Plain Language Disclosure Proposing Release*, Release No. 33-7380 and *Plain Language Disclosure Adopting Release*, Release No. 33-7497 (28 January 1998).
  - 19 There is no over-arching plain language requirement in Canadian securities laws. Nonetheless, plain language policy statements have been incorporated into many of the primary disclosure instruments and rules. See for example, (i) s 4.2 of the Companion Policy to National Instrument 44-101—*Short Form Prospectus Distributions*; (ii) s 1.2 of the Companion Policy to Ontario Securities Commission Rule 41-501—*General Prospectus Requirements*; (iii) s 2.2 of the Companion Policy to National Instrument 43-101—*Standards of Disclosure for Mineral Projects*; and (iv) s 1.5 of the Companion Policy to National Instrument 51-102—*Continuous Disclosure Obligations*.
  - 20 For example, under National Policy 11-201—*Delivery of Documents by Electronic Means* ( 'NP 11-201' ) regulators recommend that deliverers make a paper version of every document delivered by electronic means available at no cost to a recipient upon request of such recipient, regardless of the form in which the document was originally delivered. Moreover, with respect to the required form and content of electronic document, NP 11-201 requires the current paper version be recreated in electronic format (instead of simply being scanned into electronic format).
  - 21 Statistics Canada reported in 2004 that 64 percent of households in Canada have at least one member who uses the internet with 65 percent of users having a high speed connection. See Report at 60.
  - 22 See <http://www.bsc.bc.ca/policy.asp?id%45272>.
  - 23 See sch 4A in vol 1 of the Report.
  - 24 C. Cakebread, *'Investor Education in Canada: Toward a Better Framework'* in vol 3 of the Report at 357.
  - 25 Study by NBCN Prime Brokerage Services and reported in *Benefits and Pension Monitor*, 10 January 2007. [www.bpmmagazine.com/bpm/news/index.html](http://www.bpmmagazine.com/bpm/news/index.html).
  - 26 W. Voorheis: *'Collapse of Portus Asset Management Inc. and Norshield Asset Management Ltd.'* vol 3 at 231 – 245.
  - 27 See n 26 above, at 240.
  - 28 U. Bhattacharya, *'Enforcement and its Impact on Cost of Equity and liquidity of the Market'*, vol 6 of the

- Report.
- 29 P. Cory and M. Pilkington, '*Critical Issues in Enforcement*', vol VI at 171 of the Report. Their views were also formed with the assistance of a board of experienced Canadian securities practitioners.
- 30 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 (L. Cunningham, '*Principles and Rules in Public and Professional Securities Law Enforcement: A Comparative US-Canada Inquiry*', vol 6 of the Report. Another study examined the development of 'compliance cultures' and useful regulatory techniques for fostering compliance (M. Condon and P. Puri, '*The Role of Compliance in Securities Regulatory Enforcement*', vol 6 of the Report).
- 31 H. Jackson, '*Regulatory Intensity in the Regulation of Capital Markets: A Preliminary Comparison of Canadian and U.S. Approaches*', vol 6 of the Report.
- 32 This is a summary only. More detailed discussion can be found in the Report.
- 33 In making these recommendations, the Task Force was, however, mindful of the more gradual recommendations in the Cory and Pilkington Report in this regard, which stated that every reasonable effort should be made to accomplish the same result within the current court system.
- 34 A review of the financial analyst literature and a set of recommendations was prepared for the Task Force by S. Choi, '*Thoughts on the Regulation of Investment Analysts in Canada*', vol 6.
- 35 S. Rousseau, 'The Competitiveness of Canadian Stock Exchanges: *What Can We Learn from the Experience of the Alternative Investment Market?*' and J. Board and S. Wells, 'The LSE's AIM Market: Effect on Returns and Trading of Canadian Stocks' vol 5.
- 36 T. Baker, '*Insurance Against Misinformation in the Securities Markets*', vol 2 of the Report.
- 37 H. Panjer, '*Insurance Against Misinformation in the Securities Markets: Actuarial Aspects*', vol 2 of the Report.
- 38 The study is based on a paper by L. Zingales, '*Is the U.S. Capital Market Losing its Competitive Edge?*' forthcoming *J Econ Perspect*.