

**Expert Panel on Securities Regulation**  
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I am writing at the request of The Honourable Tom Hockin who asked me to make a formal proposal to the Expert Panel no later than July 15, 2008. In particular, I am asked to state how my views have evolved since the Crawford Panel on a Single Canadian Securities Regulator and the Task Force to Modernize Security Regulation in Canada (called “Canada Steps Up”). The Crawford Panel is a valiant attempt to continue securities regulation in a new guise under the fallacious concept that “Average Canadians are very protected consistently throughout the country”.

“Canada Steps Up” is a large report, funded by the Investment Dealers Association of Canada, which focused on how existing securities regulators could do a better job. It came out in October 2006, 3 months after the Crawford Panel. It covered many substantive areas that are very important but have been largely ignored by the various securities regulators. A clear example is that, until Finance Minister Flaherty announced new rules for disclosure on PPN’s starting July 1, the Securities Regulators did almost nothing despite the major coverage of PPN’s in “Canada Steps Up” two years ago. We need a Federal presence. In my view, the concepts of securities regulation as we have know them in Canada to-date, are largely based on the *Securities Act* of 1933 and the *Securities Exchange Act* of 1934 of the United States, together with many subsequent concepts of the Securities Exchange Commission and more recent legislation like Sarbanes Oxley. It is time for a change. Securities legislation across Canada has developed in the provinces and territories as a result of Federal inaction. While there have been a plethora of suggestions for a single regulator, there has been no consensus developed and new approaches to the major problems are not being addressed.

Currently, it appears that a significant change is being proposed in the United States, which will result in a new regulatory body spanning the commodity markets as well as the capital markets. To-date, there has been little regulation of commodity trading, whether in Canada or the United States, yet this form of trading has likely surpassed the trading in the capital markets. Accordingly, the concept of “securities regulation” as known today is likely irrelevant, but the door is open for a new form of regulation and the Federal government could construct legislation to embrace this new phenomena.

The first requirement is to recognize that the Canadian market is a small but integrated part of the American market. It is not a part of the European Market. For example, many of Canada’s largest corporations are listed on exchanges in the Untied States. Now that the merger of the Montreal Exchange Inc. and the TSX Group is complete, the Canadian market is unified as never before. It gives the Federal government an opportunity to act in a positive manner to regulate the new era. It is not hobbled by the past. Canada needs a new “*Capital and Commodities Markets Act*” run by the Federal Government. Small and medium-sized corporations are important in Canada and deserve more astute regulatory consideration, which the existing securities regulators have not satisfied.

In 1971, Robert Dickerson produced the Proposals for a New Business Corporations Law For Canada. Those proposals became the *Canada Business Corporations Act* in 1975. Despite some provincial objections, the CBCA provisions were adopted in most of the provinces because it was sensible, modern legislation. The CBCA was revised in 2002, and remains the

pre-eminent corporate statute in Canada. Recently, I received a letter from Ottawa asking for my suggestions of the “Harmonization of Federal Legislation with the Civil Law of the Province of Quebec”. I was outraged to find that the CBCA was the statute to be “harmonized”. I find it revolting to find the Federal corporate law, recognized since 1881 as a power of the Federal government and now followed by the corporate law of most provinces, is to be “harmonized” with the law of only one province! I worry that your Expert Panel will have to “harmonize” any legislation with the *Quebec Civil Code*. Indeed, the “harmonization” proposed for the CBCA has already projected new definitions for put and call options, changing the words “transferable by delivery” to “negotiable by delivery”, which are not the definitions in common use in English nor do they carry the same legal meaning. Your Panel must ensure that the new Federal legislation relating to Canadian commodity and capital markets recognizes that English is the only language used in these markets. Of course there can be a French translation for any statute but the English provisions will be the only ones acceptable across Canada. If there is any hint that all or most senior officers must be bilingual, there will be no agreement by the provinces to accept any Federal initiative.

The current securities regulation in Canada and the United States is based on the concept of full disclosure. This has allowed lawyers and accountants to obfuscate such disclosure so that the resulting material is verbose and unintelligible. I suggest that concepts such as “fairness” are much better and should not be allowed to be trumped by disclosure, however truthful. This is a change that needs to be initiated – short documents with easily understood disclosure that ensure fairness in the markets and fairness to the stakeholders. Serious, knowledgeable individuals such as John Bogle (Vanguard Funds) and Arthur Levitt (former SEC Chairman) are particularly worried by the deficiencies in existing financial reporting of earnings. Between 2000 and 2005, 1,600 public companies in the United States restated their earnings. Meanwhile, of the latest 10 new billionaires in the United States, 5 were Hedge Fund Managers. Far too much money is diverted from investors to mutual fund companies and hedge fund managers, as Bogle shows in his recent book “The Battle for the Soul of Capitalism”. But mutual funds, resulting from pension plans, and hedge funds are the major factors for secondary trading. A new approach is required.

My basic approach to the Panel would be to recognize that a strong Federal initiative is mandatory. The Federal government has the constitutional power in every important sector required to regulate the markets and that regulation is now manifestly beyond the ability of any of the provinces. I am referring to Income Tax, Criminal Law, Banks and Competition Law. These are Federal powers and should form the basis of your approach.

Enforcement has proved to be a complete disaster at the provincial securities commission level, whether or not criminal action has been involved. Here I will only mention two areas. The first is insider trading where the Fingold, Rankin and Cowpland cases showed that the Ontario Securities Commission was unable to effectively enforce insider trading rules. The Federal government, as part of its efforts to co-ordinate and strengthen enforcement against capital market frauds, including insider trading, created Integrated Market Enforcement Teams (IMETS) in Toronto, Vancouver, Montreal and Calgary. Unfortunately, IMETS has not worked at all, as “Canada Steps Up” noted at pages 119-20, largely because the provincial regulators do not use IMETS effectively. The second area where criminal law has been a complete failure when enforced by the Securities commissions involves the scandals of BreX, Nortel, Livent, YPM and Hollinger. That it was up to the U.S. courts in Chicago to convict Lord Black, shows

how incompetent Canadian enforcement has become. The Federal government must use the Criminal Law power in conjunction with the new statute to get rid of the “Canada discount” which is widely believed to discourage international investors who are considering investing in Canadian equities. This may need a special capital markets court where the judges are knowledgeable of modern approaches involving capital market theory, derivatives, risk analysis and mathematical concepts.

“Canada Steps Up” also acknowledged the necessity to regulate hedge funds, which the securities regulators have ignored. Most of the Canadian activity in hedge funds involves the banks. In Canada, the banks own or control a large percentage of all the investment dealers. This was not the case 20 years ago but now it makes Federal regulation under the Banking power a necessity. In addition, the banks are ganging up to control trading, which has been largely the domain of the TSX Group. Whether or not this is healthy, the Federal government should look into the manner in which the banks now operate their investment dealers. The recent huge losses of the Canadian banks are also of concern and should be scrutinized by the regulators. The problem of asset-backed securities in the commercial paper markets was clearly orchestrated by the banks, but where was the regulator? Again, I suggest it is essential for the Federal government to oversee more clearly the actions of the banks as they relate to the commodities and capital markets. It is common knowledge that the underwriters of IPOs only allow their friends to participate in the initial offering. These “friends” sell the securities, which always go up initially, and regular investors are then the secondary owners of the shares, which may go down in value, as Binnie J. pointed out in the Danier case. Another problem exists with respect to dealing with beneficial shareholder communications, which shareholders hold over 80% of the securities of Canadian public issuers and are now to be divided into Objecting Beneficial Owners (OBOs) and Non-Objecting Beneficial Owners (NOBOs) under National Instrument 54-101.

A very major problem in the capital markets is the awarding of stock options to senior officers. This has been structured in the *Income Tax Act* in such a way that the stock option is only bought when the underlying stock is sold. The idea was initially to have the senior officers own shares, but the structuring in section 110(1)(d) of the *Income Tax Act* has resulted in the immediate sale of the shares subject to option. There are many more examples of tax impacting the capital markets, as the Paulson & Co. fight with Algoma Steel Inc. showed (see [2006] O.J. No.36).

It is obvious that the *Competition Act* in Canada and the Antitrust Statutes in the United States have become paper tigers. Canada needs a new strong competition regulator especially in the capital and commodities markets. Those markets are now run by a small group of individuals who all operate in the same manner, with their major objective being to make more money for themselves. Bogle estimates 100 institutional managers now alone hold 52% of all the shares listed in the United States. He notes that the emphasis on short-term market prices has resulted in an enthusiasm for financial engineering and manufactured earnings. To that I would add creative tax avoidance. It is time for a change.

In “Pay without Performance: The Unfilled Promise of Executive Compensation”, L. Bebchuk and J. Fried noted that the average top executive in 1991 received 140 times the pay of the average worker, while in 2003 that ratio had jumped to 500:1. While the economists’ paradigm is of arm’s length bargaining between executives and boards of directors, the reality is that both groups are trying to get more money for each other. The CEO controls the board of

directors, both through feeding information to the directors and having a large say about which individuals continue as directors from year to year. Directors and officers are overpaid. Two other major remuneration flaws are the inflated golden parachutes paid when a senior manager retires and exorbitant pensions. For example, Jill Ballard of Mattel received \$50 million in severance pay after being employed for 2 years while Mattel's stock price fell 50%. If directors are to be aligned with shareholder interests, there should be a majority of directors who are not former CEOs or wealthy curmudgeons.

I hope the expert panel will demonstrate a new practical approach that will result in Federal regulation and will inspire international investors to consider Canadian markets. Thank you.